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# **Corporate Insolvency Law in the 21<sup>st</sup> Century: State-Imposed or Market-Based?**

Michael Schillig\*

*Abstract: The central premise of this article is that financial innovation and the ever-increasing complexity of proprietary entitlements necessitate a principled recalibration of the boundaries of regulation and contract in corporate insolvency law, a recalibration that is already under way. Through the lens of a combination of ‘commons/anti-commons analysis’ and ‘contractualisation of bankruptcy’ models, the article critically analyses recent developments at European and national level, in particular the development and reform of the concept of Centre of Main Interest (COMI), the rise of pre-packaged administrations and the reformulation of the anti-deprivation principle. The adopted theoretical framework explains and justifies these developments and provides some guidance for future reform efforts.*

## **A. INTRODUCTION**

Since the publication of the Cork Report<sup>1</sup> more than 30 years ago, corporate insolvency law has flourished as a subject of academic enquiry. Initially perceived as a rather technical area, of relevance mainly to practitioners, the interest in a theoretical and

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<sup>1</sup> Report of the Review Committee, Insolvency Law and Practice (Cmnd. 8558) (Cork Report).

principled analysis of the complex policy issues involved has increased significantly.<sup>2</sup> With the enactment of the European Insolvency Regulation (EUIR)<sup>3</sup> corporate insolvency law in Europe has effectively become a multilayered system,<sup>4</sup> a tendency that is likely to increase. The ongoing global financial crisis has further sharpened the focus.<sup>5</sup> Major reform efforts are either under way or have already been implemented.<sup>6</sup> In the context of

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<sup>2</sup> R Goode, *Principles of Corporate Insolvency Law* (London: , Sweet & Maxwell, 4<sup>th</sup> edn 2011) para 1-01; V Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge: CUP, 2<sup>nd</sup> edn 2009) chapter 2; RJ Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford: OUP 2005).

<sup>3</sup> Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings OJ L160/1 30.06.2000.

<sup>4</sup> The EUIR is a conflict of laws instrument containing mainly rules on jurisdiction, the applicable law and the recognition and enforcement of foreign decisions. However, it also contains provisions of a substantive nature, eg Art 7(2) EUIR.

<sup>5</sup> R Bork, *Rescuing Companies in England and Germany* (Oxford: OUP 2012) para. 1.12.

<sup>6</sup> At national level: Banking Act 2009, providing a special resolution regime for commercial banks in financial distress; Investment Bank Special Administration Regulations (SI 2011/245); The Insolvency Service, *Proposals for a Restructuring Moratorium – a consultation* (July 2010).

At EU level: Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, COM(2012) 280/3; European Parliament, Directorate-General for Internal Policies Policy Department C: Citizens' Rights and Constitutional Affairs – Legal Affairs, *Harmonisation of Insolvency Law at EU Level* (2010); European Parliament – Committee on Legal Affairs, *Report with recommendations to the Commission on insolvency proceedings in the context of EU company law* (October 2010); Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) No 1346/2000 on insolvency proceedings COM(2012) 744 final (Commission Proposal); Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: A new European approach to business failure and insolvency COM(2012) 742 final.

recent developments at European and national level, this article focuses on the relationship and fault lines of mandatory, state-imposed regulation and contractual, market based solutions in the realm of corporate insolvency law. Corporate insolvency law is in many respects dependent upon, and interwoven with, contractual arrangements. In a world without debt, insolvency would be impossible and in a market economy most debt will have been created contractually. Where a company is in financial distress it may reorganise its capital structure on the basis of an informal workout involving a contractual adjustment of existing claims. A Company Voluntary Arrangement is also contractual in nature, although the contract has a statutory overlay.<sup>7</sup> And secured credit modifies the secured creditor's status in the debtor's insolvency. The formal procedures, however, subject to which a debtor is either reorganised or liquidated when insolvent on a cash flow or balance sheet basis are state-imposed and largely mandatory in nature. In principle, it is not possible for debtors and creditors to opt out of corporate insolvency law, to modify the applicable procedure or to devise their own customised procedure in, and for, a situation in which the statutory regime has been triggered.<sup>8</sup> The central premise of this article is that financial innovation and the ever increasing complexity of capital structures necessitate a recalibration of the fault lines between regulation and contract in corporate insolvency. Such a recalibration is already under way at both European and

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<sup>7</sup> Insolvency Act 1986, ss 5(2)(b) and 6; Goode (n 2) para 12-26.

<sup>8</sup> For the US Bankruptcy Code, 11 USC §§541(c)(1), 545, 365, 363(l) reflecting the *ipso facto* principle; for the UK anti-deprivation rule and the *pari passu* principle Goode (n 2) para 7-01 – 7.12; for Germany L Häsemeyer, *Insolvenzrecht* (Heidelberg: Carl Heymans Verlag, 4<sup>th</sup> edn 2007) para 2.02: insolvency proceedings as 'suspension of private autonomy'; see also Bork (n 5) para 7.04.

national levels. The article offers a theoretical justification and critical analysis of these developments.

It first explains the existence and structure of a mandatory corporate insolvency law on the basis of a combination of a ‘tragedy of the commons’ and ‘anti-commons’ analysis.<sup>9</sup> In the absence of corporate insolvency law, the creditors faced with an insolvent debtor find themselves in a common pool situation. Each creditor has an incentive to enforce his individual property rights as soon as possible, to the detriment of a potential going concern surplus – ‘fishing the pond empty’.<sup>10</sup> This can be remedied by imposing a comprehensive moratorium on individual enforcement rights and locking all creditors into a collective procedure. Where each locked-in creditor has a veto-right on the realisation and distribution of a potential surplus, a tragedy of the anti-commons may ensue: strategic bargaining and hold ups may thwart an outcome that would be beneficial to all creditors as a group. This problem may be addressed through information rights, majority voting in classes and cram down provisions. However, financial innovation resulting in increased fragmentation and fluidity of debt as well as increased complexity of property rights and distorted incentives of rights holders amplifies the anti-commons problem. The traditional mechanisms increasingly appear to be inadequate.

One possible solution consists of the *ex ante* or *ex post* re-pricing of property rights so as to make cooperation more attractive. This may be achieved, contractually,

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<sup>9</sup> For the first comprehensive assessment of corporate insolvency law in these terms see R de Weijts, ‘Harmonisation of European Insolvency Law and the Need to Tackle Two Common Problems: Common Pool & Anticommons’ Centre for the Study of European Contract Law Working Paper No. 2011-16.

<sup>10</sup> T Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, Mass.: Harvard University Press, 1986) 12.

through a ‘menu approach’ to bankruptcy<sup>11</sup> that allows the debtor company to select the optimal bankruptcy regime *ex ante* in its corporate charter from a range of different bankruptcy options (*ex ante* re-pricing). A subsequent change in the applicable bankruptcy law through charter amendment (*ex post* re-pricing), is complex and requires the adequate protection of non-consenting parties. This theoretical framework can be used to analyse the concept of the Centre of Main Interest and its subsequent change (insolvency forum shopping) under the EUIR;<sup>12</sup> and supports some concrete suggestions relevant for the current reform debate.

The ‘anti-commons’ problem resulting from forcing creditors into a collective procedure to act as one unit (‘collectivisation’) may further be resolved by a switch (back) to ‘privatization’, that is, bundling the individual enforcement rights of creditors in the hands of a single rights holder or lead creditor. The ‘contract bankruptcy approach’ is based on the notion that parties contract *ex ante* in the lending agreement for the debtor to make the optimal bankruptcy choice *ex post* when in financial distress. This can be achieved by ‘bribing’ the firm to make that optimal choice by allowing it to keep an optimal percentage of the firm’s insolvency monetary return. This approach establishes a mechanism for a switch from collectivisation to privatisation and vice versa. As such, it provides the bankruptcy-theoretical justification for the rise of pre-packaged

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<sup>11</sup> Throughout this article the term ‘bankruptcy’ is to be understood in the US-American sense of the term (and not in the sense of Part IX of the Insolvency Act 1986).

<sup>12</sup> Art 3(1) EUIR.

administrations in the UK,<sup>13</sup> as well as strong arguments for the introduction of a restructuring moratorium as envisaged by the Insolvency Service.

A more limited solution the commons/anti-commons dilemmas may be found in the insulation and separation of those creditors who are willing to cooperate from non-cooperating creditors. This may take the form of a partial privatisation or opt-out of the mandatory bankruptcy process by some creditors. The ‘waiver contract approach’ elaborates a standard for assessing under what circumstances such a partial privatisation/opt-out should be enforceable from an *ex ante* point of view. It provides a theoretical justification and basis for refinement of the test developed by the UK Supreme Court for determining a breach of the anti-deprivation principle in the context of complex financial contracts<sup>14</sup>.

The final section offers some concluding remarks on the redefinition of the boundaries between contract and regulation.

## **B. THE TRAGEDY OF THE COMMONS/ANTI-COMMONS ANALYSIS OF CORPORATE INSOLVENCY**

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<sup>13</sup> J Armour, ‘The Rise of the “Pre-Pack”’: Corporate Restructuring in the UK and Proposals for Reform’ in RP Austin and FJG Aoun (eds.) *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Sydney: Ross Parsons Centre, 2012) 43 (also available at <http://ssrn.com/abstract=2093134>; in the following, references will be to this electronic copy).

<sup>14</sup> *Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* [2011] UKSC 38.

The most prominent justification for the existence of a mandatory and collective corporate insolvency regime has been presented by Thomas Jackson in form of the ‘creditors’ bargain theory’.<sup>15</sup> The ‘creditors’ bargain’ is a hypothetical model which is designed to mirror the agreement one would expect the creditors as self-interested rational agents to form among themselves were they able to negotiate such an agreement from an *ex ante* position.<sup>16</sup> Jackson views the situations of creditors in the absence of prior agreement as a ‘classic example’ of a ‘prisoners’ dilemma’: Each creditor, unless assured of the other’s cooperation, has an incentive to take advantage of individual collection remedies, and to do so before the other creditors act. These creditors would favour the existence of a government-imposed system of collective debt enforcement because this would eliminate the costs associated with a race of the creditors on the company’s assets.<sup>17</sup> According to Jackson, this race not only creates (monitoring) costs for the individual creditor, it is also likely to lead to a premature termination of the debtor’s business since each creditor will consider only that creditor’s own advantage

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<sup>15</sup> T. Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain’, (1982) 91 Yale Law Journal 857; Jackson (n 10) 7 – 19.

<sup>16</sup> Jackson (1982) (n 15) 858.

<sup>17</sup> *ibid* 861. Secured creditors are unlikely to profit directly from these cost savings. However, Jackson argues, because the collective regime minimizes the debtor’s total credit costs to the advantage of debtor and unsecured creditors one would expect the unsecured creditors to pay the secured creditors to agree to join in the collective proceeding; *ibid* 869. In order to maintain the (assumed) efficiency gains of secured credit secured creditors are still required to be paid first out of the secured creditor’s collateral. Consequently, secured creditors would not be worse off by joining a collective proceeding and the unsecured creditors could be made better off; *ibid* 870.



from racing, not the disadvantages imposed on creditors collectively.<sup>18</sup> To the extent that maintaining the debtor's business as a going concern is likely to increase the aggregate pool of assets, the introduction of a collective enforcement regime is advantageous to the creditors as a group.<sup>19</sup>

At the heart of this approach is a 'tragedy of the commons'.<sup>20</sup> On the basis of their individual enforcement rights, creditors have access to a scarce resource in form of the debtor's assets. When the debtor is insolvent, the creditors' incentives are misaligned in the sense that the exercise of any one creditor's individual enforcement right (in priority to others) may result in a fully internalised benefit for that creditor – full satisfaction of his claim – whereas the costs emanating from the destruction of the going concern value are externalised and borne by all the other creditors as a group. Even if there is no going concern value inherent in the debtor's assets, individual enforcement action may still result in negative externalities in the sense that the other creditors may only receive a lower dividend as compared to a *pari passu* sharing in the debtor's assets. Thus, because they do not take into account all the implications of their individual enforcement action, creditors as a group will be worse off.<sup>21</sup> The misalignment of incentives is a result of the combination of individual enforcement rights with a common pool of assets. Individual rights can be used to offload costs on the common pool whilst at the same time the

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<sup>18</sup> *ibid* 862.

<sup>19</sup> *ibid* 865. For a critical assessment see R. Mokal, 'The Authentic Consent Model: contractarianism, Creditors' Bargain, and corporate liquidation', (2001) 21 *Legal Studies* 400.

<sup>20</sup> de Weijs (n 9) 2-3.

<sup>21</sup> LA Fennell, 'Commons, anticommons, semicommons' in K Ayotte and H Smith (eds) *Research Handbook on the Economics of Property Law* (Edward Elgar, 2011) 35, 36.

common pool can be accessed in order to obtain private benefits.<sup>22</sup> This ‘tragedy of the commons’ can be addressed by reducing the degree of mismatch between the individual rights and the common pool through delinking individual rights from the right of access to the common pool and by either consolidating individual rights in the hands of a single rights holder (‘privatisation’) or in the hands of a collectivity that can act as one (‘collectivisation’).<sup>23</sup> In the context of corporate insolvency, administrative receivership is an example for privatisation. A single creditor with a security over all or substantially all of the debtor’s assets can appoint a receiver to control the common pool for the benefit of the appointing creditor.<sup>24</sup> Junior creditors are prevented from exercising their individual enforcement rights against the debtor’s assets in the possession of the receiver.<sup>25</sup> By contrast, collectivisation can be observed with administration where an administrator is appointed – by the court or out-of-court<sup>26</sup> – with far-reaching powers over the debtor’s assets<sup>27</sup> and a duty to act in the best interest of all creditors.<sup>28</sup> Individual enforcement rights are transformed, subjected to a comprehensive moratorium<sup>29</sup> and

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<sup>22</sup> *ibid* 37.

<sup>23</sup> *ibid* 38-39.

<sup>24</sup> Goode (n 2) para 10-06 – 10-24.

<sup>25</sup> *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979; see also Insolvency Act 1986, s 43.

<sup>26</sup> Insolvency Act 1986, Schedule B1 para 10, 14, 22.

<sup>27</sup> Insolvency Act 1986, Schedule B1, para 59 -64 and 70-72, and Schedule 1.

<sup>28</sup> Insolvency Act 1986, Schedule B1 para 3(2). See also Goode (n 2) para 11-93.

<sup>29</sup> Insolvency Act 1986, Schedule B1 para 42, 43.

reduced to a right to participate in the creditors' meeting and to vote on the administrator's proposals.<sup>30</sup>

This is, of course, not the end of the matter. Neither privatization nor collectivisation remove the mismatch of individual rights and common pool completely; rather, a new interface between privately and commonly owned elements will appear and generate costs of its own.<sup>31</sup> Privatization may result in a mismatch of procedural power and substantive entitlement. In administrative receivership, where the secured creditor's claim has a nominal value of less than the market value of the collateral, he will lack the incentive to maximise returns.<sup>32</sup> Where a piecemeal sale of the debtor's assets generates sufficient proceeds to satisfy the secured lender's claim and to pay the receiver's fees and costs, the latter has no incentive to preserve any going concern value by continuing trading and selling the business as a going concern, even if the overall returns would be higher for the benefit of all creditors.<sup>33</sup> To that extent, the 'tragedy of the commons' will not be averted.

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<sup>30</sup> Insolvency Act 1986, Schedule B1 para 50 – 53.

<sup>31</sup> Fennell (n 21) 39.

<sup>32</sup> The Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms – Report by the Review Committee* (May 2000) para 49.

<sup>33</sup> Armour (n 13) 4. See also K Ayotte and E Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 *Journal of Legal Analysis* 511, 532, arguing, on the basis of empirical evidence, that a Chapter 11 case is more likely to result in a sale of assets, rather than a traditional reorganisation, where senior secured creditors are over-secured.

In case of collectivisation, the ‘tragedy of the commons’ may be transformed into a ‘tragedy of the anti-commons’.<sup>34</sup> There is a multitude of interactions between commons and anti-commons problems and their delineation is not entirely clear.<sup>35</sup> At a very basic level, whereas the commons problem may be said to derive from too many private access rights or ‘use privileges’ resulting in ‘over-use’ of a common resource, anti-commons is characterised by private exclusion or veto rights resulting in ‘under-use’ of a common resource.<sup>36</sup> However, on that basis, commons and anti-commons may be viewed as just different sides of the same coin. The pre-bankruptcy situation of creditors may be analysed, in accordance with the ‘creditors’ bargain approach’, as a commons problem: Too many individual enforcement rights resulting in a premature liquidation of the debtor company and over-use of the common pool – ‘fishing the pond empty’.<sup>37</sup> However, since, in the absence of a general moratorium, every creditor’s consent would be required to effectuate a workout, and every creditor would have to credibly commit to not enforcing his individual rights,<sup>38</sup> by vetoing a workout for strategic reasons a possible going concern value may be lost, thus under-using the common pool due to the exercise of veto rights. The key for a proper understanding of the distinction seems to lie in the different

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<sup>34</sup> de Weijts (n 9) 5-7; DG Baird and RK Rasmussen, ‘Anti-Bankruptcy’ (2010) 120 Yale Law Journal 648, 652-653.

<sup>35</sup> Fennell (n 21) 42-43.

<sup>36</sup> M Heller, ‘The Tragedy of the Anticommons: Property in the Transition from Marx to Markets’ (1998) 111 Harvard Law Review 621, 677.

<sup>37</sup> Jackson (n 10) 12.

<sup>38</sup> J Armour and Simon Deakin, ‘Norms in Private Insolvency: The “London Approach” to the resolution of Financial Distress’ (2001) 1 Journal of Corporate Law Studies 21 – 51.

strategic behaviour patterns of commons and anti-commons.<sup>39</sup> The commons problem resembles the strategic pattern of a Prisoner's Dilemma with one dominant strategy and one Nash equilibrium: in the absence of a credible commitment by the other creditors to cooperate, every creditor is always better off by enforcing his individual rights (or by not cooperating in a workout) because by cooperating (not enforcing) he will never realise more than he could by enforcing (full satisfaction) and will lose out if the others don't cooperate which a rational actor will anticipate.<sup>40</sup> This applies regardless of whether one focuses on the individual access rights or exclusion rights.

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<sup>39</sup> Fennell (n 21) 43.

<sup>40</sup> The respective payoff bimatrix could look as follows:

|            |                           | Creditor 2                |                           |
|------------|---------------------------|---------------------------|---------------------------|
|            |                           | Enforce (don't cooperate) | Don't enforce (cooperate) |
| Creditor 1 | Enforce (don't cooperate) | 4; 4                      | 7; 1                      |
|            | Don't enforce (cooperate) | 1; 7                      | 6; 6                      |

The socially optimal outcome would be the realization of the going concern value through cooperation (non-enforcement of individual rights). The creditors as a whole would be better off and the amount of 12 could, for instance, be split equally (bottom right). In the absence of mandatory corporate insolvency law it may not be possible for either creditor to credibly commit to cooperation. In that case, each creditor will always be better off when he enforces (does not cooperate) regardless of what the other creditor does. Under the assumption that each creditor has an equal chance of coming first in the race on the debtor's assets, the payoff for each creditor would be 4 ( $50\% \times 7 + 50\% \times 1$ ). By contrast, each creditor will have a payoff of only 1 when he cooperates and the other enforces, realizing a payoff of 7. Thus, the dominant strategy of each creditor is to enforce (not cooperate); the Nash equilibrium is represented by the top left

By contrast, the anti-commons problem is more akin to the ‘game of chicken’ with multiple equilibria and no dominant strategy where the best strategy for each individual player depends on what the other does.<sup>41</sup> A state imposed general moratorium solves the commons problem by overriding individual enforcement rights, thus preserving the potential going concern value inherent in the common pool. Parties must then decide how to realise and distribute a potential surplus. Each party has an incentive to extract as much of the surplus for itself as possible. However, by misreading the other party’s intentions or by being in error of the amount of surplus, a party may push too far, a deal may collapse and the surplus may be lost.<sup>42</sup> In particular, where a party finds itself

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corner. DG Baird, RH Gertner and RC Picker, *Game Theory and the Law* (Harvard University Press, 1994) 33-34.

<sup>41</sup> Fennell (n 21) 43-45; Baird, Gertner and Picker (n 40) 44-45. See also R de Weijts, ‘Too Big Too Fail as a Game of Chicken with the State: What Insolvency Law Theory has to say about TBTF and vice versa’, Centre for the Study of European Contract Law Working Paper Series No. 2012-13.

<sup>42</sup> Fennell (n 21) 44-45. On that basis the example above fn 40 can be modified. The creditors are now locked in a mandatory corporate insolvency law process, preventing them from exercising individual enforcement rights and temporarily preserving the common pool of assets. The creditors still have to decide how to distribute the going concern surplus. If

| they don’t reach agreement the going concern surplus will be lost and they will share the break up value on a pro rata basis. |                 | Creditor 2      |           |
|---|-----------------|-----------------|-----------|
|   |                 | Don’t cooperate | Cooperate |
| Creditor 1  | Don’t cooperate | 4; 4            | 7; 5      |
|   | Cooperate       | 5; 7            | 6; 6      |

in a monopoly position and its contribution would significantly increase the surplus, it has great incentive to hold out and demand a higher than proportionate price for cooperation.<sup>43</sup> Corporate insolvency law addresses these issues through information rights, possibly channelled through a creditors' committee,<sup>44</sup> majority voting instead of unanimity<sup>45</sup> and possibly a cram-down in order to overcome holdouts.<sup>46</sup>

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The socially optimal outcome is represented by the bottom right corner where the creditors equally share the going concern value of 12. However, each creditor has an incentive to hold out in order to extract a share of the surplus that exceeds what would be due to him on a pro rata basis. Thus, where creditor 2 holds out and creditor 1 is willing to forgo some of the surplus in order to reach agreement the payoffs may look like in the bottom left corner with creditor 2 receiving a payoff of 7 and creditor 1 of 5 (or vice versa: top right). Creditor 1 may be willing to cooperate because his payoff in that case still exceeds his payoff were the agreement to fail and both creditors would share equally in the break up value (top left corner). In this game there are multiple Nash equilibria and each creditor's optimal strategy depends on what the other does. Baird, Gertner and Picker (n 40) 44.

<sup>43</sup> Fennell (n 21) 42.

<sup>44</sup> Insolvency Act 1986, Schedule B1 para 49 with Insolvency Rules 1986 r 2.33: having acquired the necessary information about the debtor company's financial situation, the administrator shall make a statement setting out proposals for achieving the purpose of administration and its termination to be sent to every creditor and member of the company and also the registrar of companies. Pursuant to Insolvency Act 1986, Schedule B1 para 57, the creditors' meeting may establish a creditors' committee that may require the administrator to provide information about the exercise of his functions.

<sup>45</sup> In administration, the creditors' meeting decides in principle with the simple majority on the basis of the nominal value of the unsecured creditors' claims, Insolvency Rules 1986, r 2.43. Where the administrator's proposal consist of a company voluntary arrangement, a (in excess of) 75% majority applies, Insolvency Rules 1986, r 1.19(1). In case of a scheme of arrangement in respect of each class of creditors a simple majority in number and 75% majority in value is required, Companies Act 2006, s 899.

At the heart of the matter is the fact that markets are not perfect, generating substantial transaction costs, information asymmetries and ambiguities about the property rights of the parties. Debtors and creditors cannot costlessly monitor, renegotiate and enforce their agreements.<sup>47</sup> Strategic behaviour – free riding and hold up situations – may prevent creditors and debtors from reaching agreement that would maximize firm value for the benefit of all parties concerned. Mandatory corporate insolvency law is a reaction to these market failures addressing both commons and anti-commons dilemmas.<sup>48</sup> By preventing a race of the creditors on the debtor's assets corporate insolvency law seeks to maximise the aggregate return for all creditors. The potentially ensuing surplus is distributed amongst creditors on the basis of a fair and equitable system of priority of claims and majority voting.

This mandatory regime – in its different manifestations – is premised on the general assumption that on the whole (unsecured creditors) have an economic interest in the maximization of the value of the debtor company's assets.<sup>49</sup> The participants are identifiable and their respective property rights are sufficiently well defined. However, this general assumption seems to have lost some of its plausibility. The 'derivatives

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<sup>46</sup> Whereas the rights of dissenting secured creditors may not be overridden in administration or under a company voluntary arrangement, a cram down of the rights of secured creditors is possible in a scheme of arrangement subject to court approval, Insolvency Act 1986, s 4(5), Schedule B1 para 73(1); Companies Act 2006, s 899. Goode (n 2) para 12-13.

<sup>47</sup> E Warren, 'Bankruptcy Policymaking in an Imperfect World', (1993) 92 Michigan Law Review 336, 379.

<sup>48</sup> de Weijts (n 9) 2.

<sup>49</sup> Baird and Rasmussen (n 34) 654.



revolution', technological innovation and the development of equity and debt trading techniques allows equity and debt investors as well as directors and executives to rearrange and modify their property rights by de-coupling and reassembling economic interests and control rights, resulting in increased complexity and fragmentation of proprietary interests.<sup>50</sup> This is apparent from the exponential growth of the credit derivatives market.<sup>51</sup> A creditor may hedge its exposure to the default risk of the debtor by holding a 'credit default swap' (CDS). Under a simple CDS, if a 'credit event'<sup>52</sup> occurs the protection seller will compensate the protection buyer based on the difference between the nominal value of the credit instrument and its market value shortly after the credit event.<sup>53</sup> During the swap term the protection buyer typically pays the seller a fixed

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<sup>50</sup> HTC Hu and B Black, 'The New Vote Buying: Empty Voting and Hidden Ownership' (2006) 79 Southern California Law Review 811; 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 University of Pennsylvania Law Review 635; 'Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications' (2008a) 14 European Financial Management 663.

<sup>51</sup> By the end of June 2011 the total notional amount of outstanding credit default swaps was more than \$32 trillion, Bank for International Settlements, OTC derivatives market activity in the first half of 2011 (November 2011) 15. Prior to the Global Financial Crisis the market had already doubled in size between 2006 and 2007, reaching \$29 trillion. E Avgouleas, *Governance of Global Financial Markets* (CUP, 2012) 48.

<sup>52</sup> "Credit event" may be the opening of formal insolvency proceedings, payment default or an informal workout.

<sup>53</sup> Under the CDS the protection buyer will be entitled to payment even if he does not hold and never held the underlying credit instrument. In this respect a CDS differs from a contract for insurance which in most cases will only provide protection if the insured holds an insurable interest.

periodic amount. Although fully hedged through the CDS, the protection buyer retains all contractual rights under the credit instrument and may exercise, dispose of, waive or renegotiate these rights and vote on an administrator's proposal, a CVA or a scheme of arrangement.<sup>54</sup> Through securitisation, via 'collateralised debt obligations' (CDOs), a pool of debt contracts or instruments is transferred from the originator to a special purpose vehicle (SPV).<sup>55</sup> The returns from the pool are repackaged into separate tranches based on difference in credit quality. The SPV issues financial instruments backed by the underlying debt contracts or swaps to be sold off to investors. Under these structures the contractual control rights may remain with the originator or may lie with the SPV. The holders of the tranches will be exposed to the economic interest, but only partially since the SPV's portfolio will usually be highly diversified.<sup>56</sup> Not only may the economic interests of tranches differ widely, CDO investors may be fully or partly hedged and spread throughout the world. This, in combination with actively trading their positions, will make the identification of the holders of the ultimate economic interest very difficult.<sup>57</sup> With the emergence of hedge funds and private equity groups as important players, replacing in some areas traditional commercial banks as sources of capital,

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<sup>54</sup> Hu and Black (2008a) (n 50) 679-680; F Partnoy and D Skeel, 'The Promise and Perils of Credit Derivatives' (2007) 75 University of Cincinnati Law Review, 1019, 1021-1022.

<sup>55</sup> In a 'cash CDO' a portfolio of outstanding debt is actually transferred to the SPV; whereas in a 'synthetic' CDO the SPV creates synthetic exposure to credit risk by entering into a series of credit default swaps with a third party; Hu and Black (2008a) (n 50) 686; Partnoy and Skeel (n 54) 1022.

<sup>56</sup> Hu and Black (2008a) (n 50) 686-687.

<sup>57</sup> *ibid* 687.

trading in distressed debt has become more and more prevalent.<sup>58</sup> These funds are largely unregulated and unconcerned with adverse publicity. They often invest by using highly leveraged and complex financial arrangements in order to increase their returns.<sup>59</sup> Distressed debt trading allows the small and undiversified debt holder an easy exit from the corporate insolvency process; the investor in distressed debt will seek to realise a premium on its investment by exploiting superior knowledge about the debtor company or the insolvency process, by trying to gain control of the debtor or simply by trying to extract a higher than proportionate return in negotiations over the restructuring of the debtor.<sup>60</sup> In any case, traders in distressed debt and CDO investors have their own agendas which do not necessarily coincide with a successful corporate rescue of the debtor's business. Moreover, the use of credit derivatives may even result in a creditor's economic interest being negative so that he may profit from a premature liquidation and may actively encourage it.<sup>61</sup>

These developments amplify the significance of the 'tragedy of the anti-commons'. The heightened complexity through debt fragmentation and de-coupling, the resulting realignment of incentive structures as well as the appearance of new and opaque players make it more difficult to correctly identify and assess the incentives of the other players and calculate their behaviour in a scenario where there is no dominant strategy.<sup>62</sup>

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<sup>58</sup> Baird and Rasmussen (n 34) 659.

<sup>59</sup> Finch (n 2) 135-136.

<sup>60</sup> Baird and Rasmussen (n 34) 661.

<sup>61</sup> Hu and Black (2008a) (n 50) 693-694.

<sup>62</sup> Fennell (n 21) 45; Armour (n 13) 14: 'The greater the number of parties involved in such negotiations, and the wider their range of interests, the more difficult it will be to achieve agreement.'

This increases the likelihood that any one party will hold out and push too far so that a surplus enhancing deal may collapse. The resulting deadlock perpetuates the tragedy. The ensuing anti-commons problem interposes itself between the initial commons problem (‘creditors’ bargain’) and its solution through collectivisation.<sup>63</sup> By imposing a comprehensive moratorium, creditors are no longer able to exercise their individual enforcement rights, thus preserving the common pool. At the same time the participants are locked in an anti-commons situation with their individual property rights transformed, re-defined and priced in a particular way.

There seem to be (at least) three possible ways to alleviate these problems. First, the property rights of the participants locked in the anti-commons situation could be redefined thereby re-pricing the choice between cooperation and defection.<sup>64</sup> Re-pricing

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<sup>63</sup> Fennell (n 21) 46.

<sup>64</sup> *ibid* 45. It is possible to modify our example above fn 40 by redefining the creditors’ property rights in the anti-commons situation. One route to overcoming the anti-commons tragedy is to punish individual defection, M Heller, ‘The Tragedy of the Anticommons: Property in the Transition from Marx to Markets’, *The William Davidson Institute, Working*

| <p><i>Paper No 40</i>, February 1997, 72. Creditors’ rights could be redefined in the sense that the non-cooperating creditor will always be subject to a 50% tax on any dividend paid on his claim.</p> |                 | Creditor 2      |           |
|--|-----------------|-----------------|-----------|
|  |                 | Don’t cooperate | Cooperate |
| Creditor 1   | Don’t cooperate | 2; 2            | 3.5; 5    |
|  | Cooperate       | 5; 3.5          | 6; 6      |

may occur either *ex ante* or *ex post*. In a world of increased fragmentation and fluidity of property rights it is very difficult to devise a one-size-fits-all property rights regime that would be appropriate in all cases. A possible solution would be to give the parties involved a choice to opt for a property rights regime that better fits their anticipated individual incentive structures – re-pricing their property rights *ex ante*. *Ex post* re-pricing is more problematic. A market based solution may itself be subject to strategic bargaining and hold ups. State intervention may be inadequate due to information deficits, political capture, administrative complexities and the cost of compensation.<sup>65</sup> The anti-commons situation, caused by collectivisation, could further be overcome by switching from collectivisation to privatisation (and possibly *vice versa*) depending on the respective situation the debtor and the creditors find themselves in.<sup>66</sup> Again, this

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Under these circumstances cooperation is the dominant strategy for each creditor. The Nash equilibrium coincides with the socially optimal outcome represented by the bottom right corner. However, in practical terms this solution may be difficult to implement. It will be difficult to decide *ex ante* whether there is a going concern surplus inherent in the common pool. If not, cooperation (through prolonged negotiation) would itself be a waste of time and resources. It may also be difficult to decide whether any one creditor is a non-cooperating creditor liable to the 50% tax. This is to a large extent due to the valuation problem: it will be difficult to determine the value of the common pool and a potential going concern surplus. This makes it difficult to decide whether a particular creditor is holding out and demands more than would be due to him on a *pro rata* basis.

<sup>65</sup> Heller (n 36) 679.

<sup>66</sup> See also D Skeel, ‘Competing Narratives in Corporate Bankruptcy: Debtor in Control vs. No Time To Spare’ (2009) 4 Michigan State Law Review 1187, 1203: ‘[T]he coexistence of several possible narratives could assure a closer correspondence between the narrative and the underlying facts in any given case.’

switch could be market based or state imposed with the respective attendant problems. Finally, it may be possible to insulate the participants who are willing to cooperate from the defectors in order to allow the co-operators to generate some surplus from (part of) the common pool albeit not realising its full potential. In order to prevent negative externalities, mandatory rules would have to ensure that partial cooperation is only allowed to the extent that co-operators do not encroach on the property rights of defectors. An example is the subordination of debt. The agreement between creditors to the effect that the subordinated creditor cannot collect from the debtor until the senior creditor has been paid in full is valid and enforceable in the debtor's insolvency because the subordination does not affect the rights of the remaining creditors.<sup>67</sup> It may also be possible to release one or more creditors from the grip of the anti-commons situation, again provided this does not interfere adversely with the remaining creditors' property rights. This may be viewed as a form of partial privatisation or a partial opt-out of the insolvency process.

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Skeel's 'No Time to Spare' narrative is roughly equivalent to 'privatisation', whereas 'Debtor in Control' represents the collectivisation alternative.

<sup>67</sup> *Re Maxwell Communications Corp (No 2)* [1993] BCC 369, 377 per Vinolett J; *Re SSSL Realisations (2002) Ltd* [2005] [2004] EWHC 1760 (Ch) [45] per Lloyd J; *Re Kaupthing Singer & Friedlander Ltd* [2010] EWCH 316 (Ch) [10] per Blair J. Consider a debtor D with distributable assets worth 180 and three creditors A, B and C with claims of nominal 50, 50 and 100, respectively. If B and C agree that B's claim shall be subordinated to C's this will have no effect on A's entitlement. In the absence of subordination, A and B would be entitled to 25% of the distributable proceeds each (45) and C to the remaining 50% (90). With subordination, C's dividend increases to 100 whereas B's is reduced to 35. A's dividend of 45 does not change.

Corporate insolvency law as mandatory law is justified as a response to certain market failures in form of commons and anti-commons problems. However, in view of market developments and innovation mandatory corporate insolvency law may, in certain situations, aggravate the problems it is meant to address. Where this is the case, mandatory law should make room for market based solutions, facilitate them and ensure that the entitlements of non-participating parties are not unjustifiably interfered with. This requires the striking of a new optimal balance between mandatory provisions and default rules, a balance that may change over time with the development of new lending practices and financial products. The financial innovation and market developments of the last decades necessitate the adequate recalibration of the relationship between mandatory law and contract, between state intervention and market-based solutions. Such a recalibration is already under way and its different manifestations may be conceptualised in accordance with the models developed in the course of the vigorous ‘contractualisation of bankruptcy’ debate unfolding in the United States over the last 20 years, challenging, and trying to re-define, the traditional relationship of mandatory corporate insolvency law and contract.<sup>68</sup> These different models correspond to the

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<sup>68</sup> B Adler, ‘Finance’s Theoretical Divide and the Proper Role of Insolvency Rules’ (1994\_) 67 Southern California Law Review 1107; B Adler, ‘Financial and Political Theories of American Corporate Bankruptcy’ (1993) 45 Stanford law Review 311; B Adler, ‘A Theory of Corporate Insolvency’ (1997) 72 New York University law Review 343; B Adler, ‘A World without Debt’ (1994) 72 Washington University Law Quarterly 811; M Bradley and M Rosenzweig . ‘The Untenable Case for Chapter 11’ (1992) 101 Yale Law Journal 1043; R Rasmussen, ‘Debtor’s Choice: ‘A Menu Approach to Corporate Bankruptcy’ (1992) 71 Texas Law Review 51; R Rasmussen, ‘A New Approach to Transnational Insolvencies’ (1997) 19 Michigan Journal of International Law 1; R Rasmussen. ‘Empirically Bankrupt’ (2007) Columbia Business

commons/anti-commons solutions discussed above as well as to current developments in European and domestic corporate insolvency law.

### C. MENU APPROACH

As a possible solution to the anti-commons problem, *ex ante* and *ex post* re-pricing of property rights could be achieved on the basis of a ‘menu approach’ to bankruptcy. According to Rasmussen’s ‘menu approach’, bankruptcy law is simply an implied term of the contract between a firm and those who extend credit to it.<sup>69</sup> The applicable bankruptcy law determines the payment that the lender will receive when the firm is in general default. Consequently, the lender will factor it into its lending decision. The interest rate will depend on the quality of the applicable bankruptcy law. Bankruptcy law is no different from general commercial law, its mandatory nature an anomaly requiring

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Law Review 179; A Schwartz, ‘A Contract Theory Approach to Business Bankruptcy’ (1998) 107 Yale Law Journal 1807; A Schwartz, ‘Bankruptcy Contracting Reviewed’ (1999) 109 Yale Law Journal 343; A Schwartz, ‘A Normative Theory of Business Bankruptcy’ (2005) 91 Virginia law Review 1199; S Schwarcz, ‘Rethinking Freedom of Contract: A Bankruptcy Paradigm’ (1999) 77 Texas Law Review 515; M Tracht, ‘Contractual Bankruptcy Waivers: Reconciling Theory, Practice and Law’ (1997) 82 Cornell Law Review 301. Opponents: L LoPucki, ‘Contract Bankruptcy: A Reply to Alan Schwartz’ (1999) 109 Yale Law Journal 317; L LoPucki, ‘Bankruptcy Contracting revised: A Reply to Alan Schwartz’s New Model’ (1999) 109 Yale Law Journal 365; S Block-Lieb, ‘The Logic and Limits of Contract Bankruptcy’ (2001) University of Illinois Law Review 503; J Westbrook, ‘The Control of Wealth in Bankruptcy’ (2004) 82 Texas Law Review 795; E Warren and J Westbrook, ‘Contracting out of bankruptcy: An Empirical Intervention’ (2005) 118 Harvard Law Review 1197.

<sup>69</sup> Rasmussen (1992) (n 68) 56.



justification.<sup>70</sup> According to Rasmussen, it cannot be justified with reference to the common pool problem that arises where creditors are left with their individual enforcement remedies. This is because the costs of such an inefficient race among creditors would ultimately be borne by the equity holders in form of higher interest rates, and the equity holders are best placed to select the rule that provides for the largest expected return.<sup>71</sup> The further arguments for mandatory bankruptcy – need for standardization and limitation of strategic behaviour – are addressed by making available a ‘menu of bankruptcy options’. Upon formation, the firm would be required to select one option from the menu (or devise its own bankruptcy contract) in its corporate charter. The firm’s creditors would, thus, be on notice of the applicable bankruptcy law.<sup>72</sup> The problem of strategic manipulation requires that the firm’s ability of changing its initial selection after it has incurred debt must be restricted. In general, such a change would require consent of all creditors. However, a change that would not result in a transfer of wealth from creditors to shareholders/managers would be possible without creditors’ consent. This would be the case, under Rasmussen’s model, when a debtor changes from Chapter 11 to Chapter 7, thus giving up equity holder protection for the benefit of creditors.<sup>73</sup> Moreover, non-consensual creditors require protection through mandatory provisions unalterable by contract. Rasmussen does not discuss in what form this protection should be provided; he merely refers to the literature on unlimited liability of shareholders and/or directors for tort claims, or priority for tort (and possibly other non-

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<sup>70</sup> *ibid* 63.

<sup>71</sup> *ibid* 64.

<sup>72</sup> *ibid* 66.

<sup>73</sup> *ibid* 116-118.

consensual, in particular tax) claims, respectively.<sup>74</sup> In a later paper Rasmussen extended this approach to international insolvency.<sup>75</sup>

Rasmussen's rejection of the common pool analysis is not entirely convincing. It rests on the premise that debtors and creditors can either avoid the common pool problem altogether by structuring the allocation of rights accordingly, or at least minimise it through compensating creditors *ex ante* for their expected losses.<sup>76</sup> The former can be achieved by owing a single secured creditor more than the firm would be worth;<sup>77</sup> or by having only one creditor; or by having only equity investors and no creditors at all. Obviously, corporate insolvency law has no role to play where the parties can work out the debtor's difficulties prior to actual insolvency which is more likely where there is only one creditor, secured or unsecured. And without any creditors the firm cannot even be insolvent. The common pool problem arises where these options are not available for whatever reason, resulting in a multitude of different creditors with their own agendas. It is also difficult to see how the notion of *ex ante* compensation can overcome the common pool problem. If we return to our two creditors in the example n 40 and assume that their respective claims of nominal 7 contain the (promised) optimal *ex ante* compensation in form of an appropriate interest rate, their decision-making patterns would not change and in terms of social welfare it would still be wasteful to not preserve the going concern value, if any. As a consequence of this lack of engagement, the 'menu approach' has little

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<sup>74</sup> *ibid* 67 with n 52.

<sup>75</sup> Rasmussen (1997) (n 68).

<sup>76</sup> Rasmussen (1992) (n 68) 64-65; R Picker, 'Security Interests, Misbehaviour, and Common Pools' (1992) 50 University of Chicago Law Review 645, 647-648.

<sup>77</sup> Picker (n 76) 648.

to say on the commons problem. It is however significant in terms of the anti-commons problem. The ‘menu approach’ increases choice and allows the parties to opt *ex ante* for the optimal definition and pricing of property rights so as to make subsequent cooperation more likely. Provided non-adjusting creditors are adequately protected by mandatory law, there seems to be no valid justification for denying parties that choice. Mandatory corporate insolvency law should not be an end in itself; where its application is counterproductive in terms of the objectives it seeks to achieve, parties should be able to rely on market-based solutions. *Ex post* re-pricing is more difficult however, and possible under the ‘menu approach’ only where unjustified wealth transfers from debt to equity are excluded; or otherwise consent of all creditors is required. However, it does not seem to be impossible to device a mechanism that could address these difficulties.

*Ex ante* re-pricing in line with the ‘menu approach’ is currently possible to some extent pursuant to Arts 3 and 4 of the EU Insolvency Regulation.<sup>78</sup> By establishing its Centre of Main Interest (COMI) in a Member State, a firm can choose the corporate insolvency law of that Member State as the applicable insolvency law and as an implied contract term in the contracts with its lenders. The different insolvency laws of the Member States constitute the different pricing options on the menu a firm can choose from. This was even recognised in the Virgos/Schmit Report.<sup>79</sup> The strong presumption

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<sup>78</sup> Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings OJ 2000 L160/1.

<sup>79</sup> When it says that ‘[i]nsolvency is a foreseeable risk. It is therefore important that international jurisdiction (...) be based on a place known to the debtor’s potential creditors. This enables the legal risks which would have to be assumed in the case of insolvency to be calculated.’ M. Virgos and E. Schmit, *Report on the Convention on Insolvency Proceedings*, EU Council Document (1996, Brussels), point 75.

in favour of the registered office,<sup>80</sup> to be determined in a company's statutes, and the 'objective and ascertainable' criterion<sup>81</sup> addresses the problem of giving notice to creditors. However, the fact-sensitivity of COMI<sup>82</sup> introduces considerable uncertainty as demonstrated by the case law on this question.<sup>83</sup> This is a considerable deviation from the 'menu approach'. Effective re-pricing is questionable if the parties cannot be sure that their selection of a pricing option from the menu will stick. The EUIR is currently under review and a number of proposals as regards the COMI concept are on the table.<sup>84</sup>

*Ex post* re-pricing on the basis of the 'menu approach' is problematic under the current regime. Because of the diversity of national insolvency laws on the menu, it

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<sup>80</sup> Case C-341/04 *Eurofood IFSC* [2006] ECR I-3831; Goode (n 2) para 15-52; Case C-396/09 *Interdil Srl*, 20 October 2011, nyr. para. 50: the presumption is not rebuttable where the bodies responsible for management and supervision are, ascertainable for third parties, in the same place as the registered office.

<sup>81</sup> Recital 13 EUIR.

<sup>82</sup> *Interdil* (n 80) para. 53: where registered office and centre of administration do not coincide, rebuttal of the presumption requires 'a comprehensive assessment of all the relevant facts'.

<sup>83</sup> For an overview of the case law B Wessels, 'COMI: Past, Present and Future' (2011) 24 *Insolvency Intelligence* 17. See also Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the application of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings COM(2012) 743 final, para 3.1.

<sup>84</sup> INSOL Europe, *Revision of the European Insolvency Regulation* (June 2012); European Parliament, *Report with recommendations to the Commission on insolvency proceedings in the context of EU company law* (October 2011); Commission Proposal (n 6); J Armour, 'Who should make corporate law? EC legislation versus regulatory competition' (2005) 58 *Current Legal Problems* 369; D Skeel, 'European implication of bankruptcy venue shopping in the US' (2006) 54 *Buffalo Law Review* 439; W-G Ringe, 'Forum shopping under the EU Insolvency Regulation' (2008) 9 *European Business Organisation Law Review* 579.

would be difficult to distinguish situations where the transfer of COMI may not result in a wealth transfer from creditors to shareholder/managers or between different classes of creditors, from those where it might. However, under the current regime, a transfer of COMI, and amendment of the applicable insolvency law regime, is possible.<sup>85</sup> However, the protection of creditors' legitimate expectations seems to be somewhat sketchy at present and dependent upon applicable national law and the mechanism employed for the COMI transfer. Where, as in *Hellas*,<sup>86</sup> the transferring entity is a limited partnership-type entity and the transfer is effectuated by substitution of the managing general partner with a newly formed company with its COMI in the Member State of destination, no effective protection may exist. Whereas the former general partner will remain liable for the entity's accrued debt, as will be the new general partner, this liability may be meaningless if both are judgment-proof corporate entities. There is further the possibility of initiating 'secondary proceedings'<sup>87</sup> or 'territorial proceedings'<sup>88</sup> under the bankruptcy law of the

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<sup>85</sup> Case C-1/04 *Staubitz-Schreiber* [2006] ECR I-701; *Interdil* (n 80) para. 54-56. Pursuant to the popular accretion method (*Anwachsung*), the company may be converted into a partnership-type entity. A newly formed company incorporated and with its headquarters and principal place of business in the Member State of destination enters as managing partner, all other remaining partners withdraw. By operation of law, all assets of the partnership will vest automatically in the newly formed company with its COMI in the Member State of destination, provided it actually operates from its new address, notifies the creditors of the change, and carries out its negotiations from there; *Re Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch) para. 3-5. This technique was used in the cases of *Deutsche Nickel*, *Schefenacker* and *Hans Brochier*. Ringe (n 88) 585-588. Only the latter case resulted in a reported court case, *Hans Brochier Ltd v Exner* [2006] EWHC 2594.

<sup>86</sup> Above (n 85).

<sup>87</sup> Art. 3(2) and (3) EUJR.

creditor if the debtor has an establishment<sup>89</sup> in that country. However, protection will be effective only where the debtor has realisable assets in the country of the territorial proceedings and where the establishment is not judgement proof.<sup>90</sup> Alternatively, lenders may seek to incorporate into their debt covenants a representation of the borrower as to where COMI is situated and an undertaking not to move COMI, as is often done in structured transactions. However, even if breach is defined as an event of default triggering the usual remedies of debt acceleration and enforcement of security interests, such a clause will have only limited effect and cannot prevent an actual transfer of COMI. Only a substantially secured creditor or group of creditors will effectively be able to prevent a transfer;<sup>91</sup> albeit in practice major creditors will almost always be consulted and the transfer will not go ahead without their approval.<sup>92</sup> Consequently, whereas some (less significant) creditors may have no say in a potential *ex post* re-pricing at all, others may be able to opportunistically veto a beneficial transfer of COMI that would allow the going concern value to be preserved for the benefit of all parties concerned. Currently, there is no framework aimed at overcoming this anti-commons problem. Thus, under

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<sup>88</sup> Art. 3(4) EUJR. Case C-112/10 *Zaza Retail BV*, 17 November 2011, nyr.

<sup>89</sup> *Interdil* (n 80) 62-64 for a definition of the term ‘establishment’.

<sup>90</sup> Directive 2008/94/EC (of the European Parliament and of the Council of 22 October 2008 on the protection of employees in the event of the insolvency of their employer, OJ EU 2008 L283/36) provides limited protection for employees in case of insolvency of their employer, and Directive 90/314/EEC (of 13 June 1990 on package travel, package holidays and package tours, OJ 1990 L158/59) for customers in the context of package travel.

<sup>91</sup> Goode (n 2) para 15-58.

<sup>92</sup> Ringe (n 84) 604-605.

current law two inefficiencies creep in: *ex ante* re-pricing is difficult because of the fact-sensitive nature of COMI; *ex post* re-pricing is problematic because of the sketchy regime of creditor protection and the absence of a mechanism to address the ensuing anti-commons problem.

In the current review of the EUIR, one focus is the concept of COMI. The recent Commission Proposal<sup>93</sup> by-and-large adopts the approach advocated by INSOL Europe.<sup>94</sup> The presumption that the COMI is the place of the registered office appears to be significantly strengthened. Only exceptionally where the company's central administration is located in a Member State other than the place of the registered office and a comprehensive assessment of all the relevant factors establishes, in a manner that is ascertainable by third parties, that the company's actual centre of management and supervision and of the management of its interests is located in that other Member State will that Member State be the COMI. This is largely a reference to the existing case law<sup>95</sup> with its multitude of different factors to be taken into account, including location of strategic, financial and operational management, cash management and pooling, recruitment, IT, branding etc.<sup>96</sup> Indeed, the COMI may even be situated in a jurisdiction other than that of the operational head office functions and the registered office.<sup>97</sup> On that basis the Proposal seems to achieve only a marginal improvement on the status quo. The Commission Proposal seeks to tackle 'abusive' forum shopping by providing an

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<sup>93</sup> Commission Proposal (n 6), Art 1(11) introducing a new Recital (13a); and (22) amending Art 3.

<sup>94</sup> INSOL Europe (n 84) 29, Art 2(a).

<sup>95</sup> Commission Proposal (n 6), Explanatory Memorandum 3.1.2.

<sup>96</sup> INSOL Europe (n 84) 32 para 2.3 – 2.4.

<sup>97</sup> *ibid* 33 para 2.5.

enhanced procedural framework for opening procedures with *ex officio* assessment of jurisdiction by the court and a right for all foreign creditors to challenge the opening decision.<sup>98</sup> Only the INSOL Europe proposal addresses the *ex post* re-pricing problem directly.<sup>99</sup> If the COMI is moved from one Member State (A) to another Member State (B) and a request for opening insolvency proceedings is lodged within one year of the move of COMI then only the courts of Member State A shall have jurisdiction to open insolvency proceedings provided the debtor has left unpaid liabilities caused when COMI was in Member State A. In that case Member State B will have jurisdiction only if all creditors of these unpaid liabilities have agreed in writing to the transfer of COMI; or the debtor company has moved its registered office to Member State B more than one year prior to the request for opening proceedings.<sup>100</sup> This is a significant improvement on the status quo as it provides some clarity in terms of creditor protection. However, it does not go far enough restricting its scope arbitrarily to those creditors whose claims came about within one year prior to the move of COMI. On the other hand, the proposal not only does not address the anti-commons problem; in fact, giving all the creditors falling within the one-year-period a veto significantly exacerbates the anti-commons problem. Indeed, one could imagine a case where only one creditor falls into the one-year-period who could then opportunistically veto a change in COMI that is beneficial to and supported by all other creditors.

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<sup>98</sup> Commission Proposal (n 6), Art 1(23) introducing a new Art 3b.

<sup>99</sup> These provisions did not make it into the Commission Proposal; Commission Staff Working Document: Executive Summary of the Impact Assessment accompanying the document Revision of Regulation (EC) No 1346/2000 on insolvency proceedings COM(2012) 744 final, SWD(2012) 417 final, para 4.3.

<sup>100</sup> INSOL Europe (n 84) 38 Art 3(1).



The most clear-cut solution in terms of *ex ante* re-pricing in line with the ‘menu approach’ would be a pure ‘registered office’ solution for COMI.<sup>101</sup> If COMI were tied to the place of the registered office it would be readily ascertainable by third parties even where business is conducted in more than one state.<sup>102</sup> Under the right to freedom of establishment (Art 49, 54 TFEU),<sup>103</sup> a firm would, upon formation, have complete freedom to choose from the European corporate and insolvency law menu.<sup>104</sup> Any distortions arising from the application of the corporate law of one Member State and the insolvency law of another to the same entity would be eliminated.<sup>105</sup> This solution would be in line with the ‘menu approach’ and facilitate effective *ex ante* re-pricing. *Ex post* re-pricing would require reincorporation which is currently possible in a safe and structured way only for the European Company (SE)<sup>106</sup> and under the Cross-Border Merger Directive.<sup>107</sup> Whereas the SE statute requires Member States to provide for the adequate

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<sup>101</sup> Armour (n 84); Skeel (n 84); Ringe (n 84).

<sup>102</sup> Armour (n 84) 415.

<sup>103</sup> Case 81/87 *Daily Mail* [1988] ECR 5483; Case C-212/97 *Centros* [1999] ECR I-1459; Case C-208/00 *Überseering* [2002] ECR I-9919; Case C-167/01 *Inspire Art* [2003] ECR I-10155; Case C-411/03 *SEVIC* [2005] ECR I-10805; Case C-210/06 *Cartesio Oktató és Szolgáltató* [2008] ECR I-9641; Case C-378/10 *VALE Építési kft* [2012] ECR I-0000 nyr.

<sup>104</sup> Ringe (n 84) 614-616.

<sup>105</sup> Skeel (n 84) 463.

<sup>106</sup> Regulation (EC) 2157/2001 of 10 August 2001, on the Statute for a European Company (SE), OJ 2001 L294/1, supplemented by Directive 2001/86/EC of 10 August 2001 on employee participation, OJ 2001 L294/22.

<sup>107</sup> Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005, on cross-border mergers of limited liability companies, OJ 2005 L310/1.

protection of creditors in case of a transfer of seat,<sup>108</sup> the Cross-Border Merger Directive refers to the law of Member States in this respect,<sup>109</sup> which in turn must comply with the Third Company Directive on Mergers.<sup>110</sup> In this respect, national law has to provide for an adequate system of safeguards for creditors whose claims have arisen prior to publication of the draft terms of merger and not yet fallen due. Creditors whose claims have fallen due by then are not protected but can immediately enforce their claims. As a minimum standard, national law must provide that a creditor has a right to request additional security provided that they can credibly demonstrate that due to the merger the satisfaction of their claim is at stake'.<sup>111</sup> This system is unsatisfactory because protection does not extend to all creditors whilst on the other hand allowing major and secured creditors to effectively block reincorporation.

Following the Court's decision in *Cartesio*<sup>112</sup> there is renewed interest in legislative intervention at European level in respect of a transfer of a company's

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<sup>108</sup> Art 8(7) of Regulation (EC) 2157/2001 of 10 August 2001, on the Statute for a European Company (SE), OJ 2001 L294/1.

<sup>109</sup> Art 4(1)(b) and (c) of Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005, on cross-border mergers of limited liability companies, OJ 2005 L310/1.

<sup>110</sup> Art 13 of Directive 2011/35/EU of the European Parliament and of the Council of 5 April 2011 concerning mergers of public limited liability companies, OJ EU 2011 L110/1; formerly Third Council Directive 78/855/EEC of 9 October 1978, based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies, OJ 1978 L295/36.

<sup>111</sup> S Grundmann, *European Company Law*, (Intersentia, 2<sup>nd</sup> edn 2011) 686.

<sup>112</sup> Above (n 103).

registered office/head office.<sup>113</sup> If COMI were tied to the place of the registered office such an instrument should also address the *ex post* re-pricing problem. Obviously, as long as creditors are paid as and when their claims fall due, there is no reason to give them a say in a company's decision to transfer its seat (although in practice the major creditors will be consulted). This changes however when the company is in financial distress. One possible mechanism to deal with this distinction could be making a transfer of seat dependent on the company's directors issuing a solvency statement certifying that the company will be able to pay its debts as they fall due for at least the current and the following financial year, backed by personal liability of the issuing directors. Where the directors do not issue a solvency statement because the transfer of seat is carried out in order to restructure under a more favourable insolvency law, all creditors whose claims would be impaired by the move should have a say, without, however, being able to veto the change in COMI. This could be achieved through a voting mechanism where creditors are divided into, and vote in, different classes in accordance with their respective property rights under the applicable insolvency law of the Member State of origin. The COMI change would then be carried out only where a majority of classes approve, with majority voting also within the separate classes. This could be combined with substantive safeguards, such as a version of the absolute priority rule. The change in COMI may be 'crammed down' on a dissenting class only if this class would have at least the same priority under the law of the new COMI and no previously junior class

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<sup>113</sup> Council of the European Union, 'The Stockholm Programme – An open and secure Europe serving and protecting the citizens' Document 17024/09, 33; J Borg-Barthet, *The Governing Law of Companies in EU Law* (Oxford: Hart Publishing, 2012) 142-170.

would obtain under the new COMI priority higher than that of the dissenting class. Such a regime could provide the basis for addressing both *ex ante* and *ex post* re-pricing in a more efficient and effective way.

However, the problems highlighted above arising from increased debt fragmentation and complexity would also affect the suggested voting regime for the transfer of COMI. Consequently, *ex post* re-pricing may fail. It is this problem for which the ‘bankruptcy contract approach’ may provide a solution.

#### **D. BANKRUPTCY CONTRACT APPROACH**

In a series of papers, Alan Schwartz seeks to improve on the ‘menu approach’.<sup>114</sup> The optimal procedure in a given case is parameter-specific depending on the borrower’s ability to carry out its projects and the type of projects it is expected to have.<sup>115</sup> This ‘state dependency’ and ‘asset specificity’ of the optimal procedure means that an initial choice of the applicable regime in the charter may no longer be optimal when the company is in financial distress. Charter amendments (*ex post* re-pricing) are cumbersome and may be too slow to enable parties to opt for the optimal regime. The solution is to contract *ex ante* in the lending agreement for the firm to make the optimal bankruptcy choice *ex post* when in financial distress. This can be accomplished by ‘bribing’ the firm to make that optimal choice by allowing it to keep an optimal

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<sup>114</sup> Schwartz (1998) (n 68) 1819.

<sup>115</sup> Schwartz (2005) (n 68) 1243-1248.

percentage of the firm's insolvency monetary return.<sup>116</sup> Two problems are immediately obvious: due to 'state dependence', the optimal procedure and, thus, the optimal bribe may vary over time; and the firm will contract at different times with different creditors whose interests may vary and possibly collide. The 'state dependency' problem is addressed by inserting into the bankruptcy contracts conversion clauses to the effect that an earlier contract will automatically convert to a new bargain made at a later stage.<sup>117</sup> Conflicts among creditors' interests are resolved on the basis of what the '*ex ante* majority' of creditors in terms of value of their claims selected in bankruptcy contracts.<sup>118</sup> One problem that remains is the issue of notice. How does a new creditor know which bankruptcy regime currently applies and how can existing creditors be made aware when the bankruptcy system subsequently changes? The answer could be a system for the registration of bankruptcy contracts. Realistically, only a firm's major lenders will spend time and effort to ascertain and negotiate the optimal bankruptcy system. Only these bankruptcy contracts would be registered with the last in time being determinative. Under this system there is room for mandatory provisions in respect of 'structural rules' that protect the integrity of the system itself, such as the automatic stay.<sup>119</sup> Moreover, non-adjusting creditors would be protected by mandatory regulation where necessary.<sup>120</sup> Through the lens of the commons/anti-commons analysis, this approach can neatly explain and justify a switch from collectivisation to privatization. The applicable

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<sup>116</sup> Schwartz (1998) (n 68) 1827-1830.

<sup>117</sup> *ibid* 1833-1836.

<sup>118</sup> *ibid* 1837-1839.

<sup>119</sup> *ibid* 1839-1849.

<sup>120</sup> Schwartz (2005) (n 68) 1243-1248, 1255.

bankruptcy bargain will be determined, in the end, by a certain lead creditor or group of creditors that can, in cooperation with the debtor, effectively control the bankruptcy process.<sup>121</sup> These are likely to be senior secured creditors with a substantial security interest on the debtor firm's assets, possibly after the injection of new funds that are vital for the firm's continued existence as a going concern.<sup>122</sup> The registration requirements for the respective security interests as new bankruptcy contracts would put existing and future creditors on notice that the bankruptcy bargain has changed.

The main criticism of the 'bankruptcy contract approach' rests on two pillars. First, there is a danger of inefficiencies resulting from a redistribution of wealth from non-adjusting creditors to lead creditors and debtor where non-adjusting creditors are inadequately protected by mandatory law.<sup>123</sup> Secondly, it is argued that a secured lead creditor has insufficient incentives to obtain the best result possible in administering the bankruptcy process. This is because his efforts to realize the value of collateral will be limited by the value of his claim.<sup>124</sup> Empirically, this criticism is supported by the abolition, subject to certain exceptions,<sup>125</sup> of administrative receivership in Britain.<sup>126</sup>

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<sup>121</sup> Westbrook (n 68) 830.

<sup>122</sup> Ayotte and Morrison (n 33) 530, stating that 'most secured debt is incurred within a year or two preceding the bankruptcy filing. There could be a close relationship between a firm's expectations in bankruptcy and its decisions to take on secured debt.' Accordingly, it 'is possible that the reasons for choosing different secured debt ratios are the same reasons driving firms' preferences over traditional reorganization and going concern sales.'

<sup>123</sup> Westbrook (n 68) 837-843. This argument is closely related to the general and inconclusive debate on the efficiency of secured credit.

<sup>124</sup> *ibid* 843-852.

<sup>125</sup> Insolvency Act 1986, ss. 72A – 72H.

One of the main reasons was the disincentive for the administrative receiver to maximize the value of the debtor company's assets beyond the nominal value of the appointing creditor's claim.<sup>127</sup> The abolition of administrative receivership as an essentially contractual enforcement regime was seen as 'a devastating commentary on the social value' of the privatisation of corporate insolvency.<sup>128</sup>

However, market-based privatisation of the corporate insolvency and restructuring process seems to have made a powerful reappearance in form of the so-called pre-packaged administration.<sup>129</sup> A pre-packaged administration is an 'arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his appointment.'<sup>130</sup> The company's business will frequently be sold to someone connected with the company,<sup>131</sup> often the incumbent management team as the only buyer on the scene. The business survives relatively intact, having shed some or all of its unsecured debt. Pre-Enterprise Act 2002 it was held in *Re*

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<sup>126</sup> By Enterprise Act 2002.

<sup>127</sup> *dti, Productivity and Enterprise: Insolvency – A Second Chance* (Cm 5234, July 2001) para 2.3; see also The Insolvency Service (n 32) para 49.

<sup>128</sup> *Westbrook* (n 68) 854.

<sup>129</sup> *Armour* (n 13) 15.

<sup>130</sup> Statement of Insolvency Practice (SIP) 16, para. 1.

<sup>131</sup> The Insolvency Service's data show that about 30% of all administrations in 2009 were pre-packed administrations. For the first half of 2009, 81% of pre-pack sales were made to parties connected with the insolvent company. The Insolvency Service, Report on the First Six Months' Operation of Statement of Insolvency Practice 16, para. 2.3 and 3.1.5.

*T&D Industries plc*<sup>132</sup> per Neuberger J. (as he then was) that an administrator could dispose of the assets of the company without the leave of the court and prior to the approval of his proposals by the company's creditors. In *Transbus International Ltd (in liquidation)*,<sup>133</sup> it was confirmed in respect of the post-Enterprise Act 2002 legislation that administrators are permitted to sell the assets of the company in advance of their proposals being approved by creditors. In *DKLL Solicitors v Revenue and Customs Commissioners*,<sup>134</sup> it was held that even a majority creditor does not have a veto on the implementation of the administrator's proposals.<sup>135</sup> By contrast, a pre-pack necessarily requires the consent of the secured creditors.<sup>136</sup> Assets subject to fixed charges and other asset-based lending techniques may be sold by the administrator only with either the consent of the creditor or by order of the court;<sup>137</sup> the latter would significantly delay the process. The holder of a qualifying floating charge<sup>138</sup> will participate by either appointing

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<sup>132</sup> [2000] 1 WLR 646.

<sup>133</sup> [2004] 2 BCLC 550.

<sup>134</sup> [2007] BCC 908.

<sup>135</sup> Because the court could, exercising its powers under Insolvency Act 1986, Schedule B1, para.55(2), authorise the implementation of those proposals, notwithstanding the opposition of the majority creditor.

<sup>136</sup> *Armour* (n 13) 16.

<sup>137</sup> Insolvency Act 1986, Schedule B1, para 70-73.

<sup>138</sup> A floating charge qualifies if created by an instrument which states that Insolvency Act 1986, Schedule B1, para. 14 applies and which purports to empower the holder to appoint an administrator; para. 14 (2). A person is the holder of such a charge if in respect of the company's property he holds one or more debentures secured by a qualifying floating charge, a number of qualifying floating charges or a qualifying floating charge and other security, which together relate to the whole or substantially the whole of the company's property; para. 14(3).



the administrator or by not interfering with the company's appointment.<sup>139</sup> According to Armour, the rise in pre-packaged administrations can be readily explained by the trend towards increased fragmentation of debt.<sup>140</sup> In accordance with the commons/anti-commons analysis, pre-packs constitute a move from collectivisation to privatisation. The consent of unsecured creditors is no longer required. Although they retain their substantive entitlements, their procedural rights are severely restricted. The restructuring deal to preserve a potential going concern surplus is struck between the debtor company and its secured creditors as a class, and possibly with old or new financiers to inject fresh capital.<sup>141</sup>

There are serious concerns with pre-packs<sup>142</sup> that mirror to some extent the privatisation of bankruptcy debate:<sup>143</sup> a pre-packaged business often has not been exposed to the competitive forces of the market and may be sold for a consideration below market value. There seems to be no incentive to negotiate a consideration that goes beyond the amount necessary to discharge the secured indebtedness and the practitioners' fees and expenses. The rights of stakeholders to participate in the decision making

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<sup>139</sup> Armour (n 13) 16. Pursuant to Insolvency Act 1986, Schedule B1 para 26(1)(b), a company wishing to appoint an administrator has to give at least five business days' notice to the holder of a qualifying floating charge so as to give him the opportunity to make his own appointment.

<sup>140</sup> Armour (n 13) 18.

<sup>141</sup> P Walton, 'Pre-packaged administrations – trick or treat?' (2006) *Insolvency Intelligence* 113.

<sup>142</sup> The issue of transparency has been addressed, at least in part, by the SIP 16 which is effective since 1 January 2009.

<sup>143</sup> Sandra Frisby, A preliminary analysis of pre-packaged administrations, Report to The Association of Business Recovery Professionals, August 2007, at 8-9; also *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch) para. 7.

process are marginal at best. Unlike in the US under a Chapter 11 pre-pack, the general creditors will not be asked to approve the proposal.<sup>144</sup> Whereas in the US a pre-packaged plan under Chapter 11 requires confirmation by the court, court involvement in a pre-packed administration is minimal.<sup>145</sup> Where the administrator is appointed by the court, he may seek directions from the court on the pre-packaged sale immediately following the appointment. Otherwise the conduct of the administrator will only be scrutinised by the court if challenged *ex post* on the basis that the interests of a creditor or member have been harmed unfairly<sup>146</sup> or that the administrator has breached his fiduciary or other duties.<sup>147</sup> And courts will normally not interfere with the administrators' commercial judgements provided that they are made in good faith and will normally allow a considerable margin of discretion.<sup>148</sup>

These features make it more likely that inefficient wealth transfers from non-adjusting creditors to shareholders/managers and lead creditors may occur, in particular when the latter two collude. Initial empirical evidence seemed to support this conclusion.<sup>149</sup> More recent data suggests, however, that pre-packs may well be beneficial

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<sup>144</sup> Walton (n 141) 114; L Qi, 'The rise of pre-packaged corporate rescue on both sides of the Atlantic' (2007) *Insolvency Intelligence* 129, 133.

<sup>145</sup> Walton (n 141) 114; Qi (n 146) 133.

<sup>146</sup> Insolvency Act 1986, Schedule B1, para. 74.

<sup>147</sup> Insolvency Act 1986, Schedule B1, para. 75.

<sup>148</sup> M Haywood, 'Pre-pack administrations' (2010) *Insolvency Intelligence* 17 at 21. *Re Kayley Vending Ltd* (n 143) para. 24.

<sup>149</sup> Frisby (n 143) 8-9: The average return for unsecured creditors turned out to be with 1% in case of pre-packs significantly lower when compared to the 3% in case of other business sales. Moreover, the average

for unsecured creditors as well. In her most recent data analysis,<sup>150</sup> Sandra Frisby found an overall average return to secured creditors of 35% in pre-packs compared to 33% in other business sales. Moreover, unsecured creditors received an overall average return of 5% in pre-packs, but only 4% in other business sales. 2% of pre-packs resulted in full return to unsecured creditors, as compared to 1% in business sale cases. The overall value enhancing effect may stem from the fact that with a pre-pack the business can be sold quickly, thus minimizing the adverse impact of public knowledge of insolvency and the restrictions of the insolvency process.<sup>151</sup> There will be continuity of contracts with customers and suppliers; and employees, as non-adjusting creditors, are more likely to be retained. Indeed, empirical research shows that in 92% of pre-packs 100% of the jobs in an insolvent company were saved as compared to 65% in other business sales. Armour has rightly pointed out that these results should be treated with caution as they are based on comparison of means only without any statistical tests. They do not take into account firm size, capital structure or other differences that may affect outcomes.<sup>152</sup> However, a recent empirical study by Polo also finds no evidence for inefficient wealth transfers from unsecured creditors to secured lead creditors. Pre-packs in the form of connected party transactions seem to be used to preserve going concern value where intangibles, reputation and employees are particularly significant for the business. The recovery rate

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return for secured creditors on pre-packs was 42% as compared to 28% in other business sales. See also *Re Kayley Vending Ltd* (n 143) para. 7.

<sup>150</sup> S Frisby, 'The pre-pack promise: signs of fulfilment?' (2010) *Recovery* 30.

<sup>151</sup> *Re Kayley Vending Ltd* (n 143) para. 6; The Insolvency Service, Report on the First Six Months' Operation of Statement of Insolvency Practice 16, para. 2.3; Frisby (n 143) 53, 70-71.

<sup>152</sup> Above (n 13) 18.

and re-filing rate is no worse than in alternative procedures.<sup>153</sup> In short, pre-packs seem to significantly reduce the bankruptcy costs for the benefit of all parties concerned, including the debtor. That the debtor participates in the going concern surplus<sup>154</sup> is in line with the ‘bankruptcy contract approach’ and constitutes the ‘bribe’<sup>155</sup> that is necessary to commit the debtor to cooperate. In the absence of any evidence for inefficient wealth transfers to the detriment of unsecured and non-adjusting creditors, there is no justification for mandatory corporate insolvency law to interfere with these market-based solutions.<sup>156</sup> The role of regulation is rightly limited to providing the legal framework – structural rules – within which these market-based solutions can flourish, such as the comprehensive moratorium and the administrator’s powers of sale.

This leaves the issue of a possible switch (back) from privatisation to collectivisation. Here, the proposed restructuring moratorium – as the necessary set of structural rules – could hold the key. The restructuring moratorium, as envisaged by the

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<sup>153</sup> A. Polo, ‘Secured Creditor Control in Bankruptcy: Costs and Conflict’ (<http://ssrn.com/abstract=2084881>).

<sup>154</sup> Critical Armour (n 13) 19.

<sup>155</sup> For a lawful ‘bribe’ in the context of the restructuring of a note issue see *Azevedo and Alvarez v Imcopa Importacao, Exportacao E Industria De Oleos Ltda et al* [2012] EWHC 1849 (Comm).

<sup>156</sup> The introduction of compulsory court approval was recently considered by the Insolvency Service (The Insolvency Service, Consultation/Call for evidence: Improving the transparency of, and confidence in, pre-packaged sales in administrations (March 2010), option 5; The Insolvency Service, Improving the transparency of, and confidence in, pre-packaged sales in administrations: Summary of consultation responses (March 2011), 36-39). In the meantime, the Government has decided not to introduce new legislation (Written Ministerial Statement, 26 January 2012).

Insolvency Service,<sup>157</sup> would provide a ‘breathing space’ for larger companies<sup>158</sup> during which a restructuring deal, in form of an informal workout, a company voluntary arrangement or a scheme of arrangement, could be negotiated whilst the incumbent management remains in control of the company.<sup>159</sup> The restructuring moratorium may become relevant for allowing a move from privatisation to collectivisation. This is because the moratorium (and the interim moratorium) would prevent the appointment of an administrator by the directors or by the holder of a qualifying floating charge, the appointment of an administrative receiver, or the application for an administration order.<sup>160</sup> At the same time, the court hearing required to sanction the moratorium would give all creditors an opportunity to represent their interests and to raise objections if they felt unfairly prejudiced.<sup>161</sup> Moreover, debts incurred during the moratorium could be given super-priority status in an immediately following administration or liquidation where in terms of priority they would be below any fixed charge on the company’s assets, but above the claims of preferential creditors and (qualifying) floating charge holders.<sup>162</sup> The point is, even where the company’s assets are subject to a qualifying floating charge,

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<sup>157</sup> The Insolvency Service, *Proposal for a Restructuring Moratorium – a consultation* (July 2010).

<sup>158</sup> Small companies may already obtain a moratorium when proposing a voluntary arrangement, Insolvency Act 1986, s 1A, Schedule A1. Eligible are companies that satisfy at least two of the following conditions: (i) not more than £6.5 million turnover; (ii) not more than £3.26 million balance sheet total; (iii) not more than 50 employees; Insolvency Act 1986, Schedule A1 para 3(2)(a), Companies Act 2006, s 382(3).

<sup>159</sup> The Insolvency Service (n 157) para 2.8.

<sup>160</sup> *ibid* para 3.7.

<sup>161</sup> *ibid* para 4.15.

<sup>162</sup> *ibid* para 4.25 with n 4.

the privatisation scenario of administration with the floating charge holder in the driving seat would no longer be a foregone conclusion. Rather, the restructuring moratorium opens up a negotiation space allowing for the participation of all creditors and giving the court wide discretion. Moreover, the super-priority facility allows for the replacement of an existing bankruptcy contract in the form of privatisation on the basis of a qualifying floating charge, with a new bankruptcy contract potentially better suited to preserve the going concern surplus. Debtor opportunism has to be kept in check through appropriate safeguards.<sup>163</sup> However, the restructuring moratorium increases the choice for parties faced with ever increasing complexity and allows them to adapt their arrangements to changing circumstances. Consequently, the work on the proposal should be continued with a view to adopting it as soon as possible.<sup>164</sup>

## **E. BANKRUPTCY WAIVERS**

Where both a comprehensive *ex ante* and *ex post* re-pricing as well as a switch from collectivisation to privatisation (or *vice versa*) fail, it may be possible to allow at least some participants to cooperate. Such cooperation may take place within the anti-commons situation, as in the case of contractual debt subordination.<sup>165</sup> More problematic

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<sup>163</sup> On the obligations of directors see *ibid* para 4.19 – 4.21.

<sup>164</sup> Following the publication of the responses to the consultation, the Government will work with stakeholders in order to refine the proposal, Written Ministerial Statement, 11 May 2011 (<http://www.bis.gov.uk/assets/insolvency/docs/insolvency%20profession/consultations/restructuring-response/restructure-response-1-parliamentarystatement.pdf>).

<sup>165</sup> Above n 67.

is the question whether the debtor may cooperate with a creditor or a group of creditors resulting in partial privatisation and a partial opt-out of these creditors from the anti-commons situation and general insolvency law principles. This issue has been discussed extensively in the context of so-called waiver contracts.<sup>166</sup> Steven Schwarcz's 'bankruptcy waiver approach' offers an interesting normative theory for ascertaining the extent to which parties should be free to contractually override provisions of the statutory bankruptcy scheme through waiver contracts.<sup>167</sup> According to Schwarcz, statutory provisions may be mandatory, under general principles of contract law, if they either pursue a paternalistic agenda or seek to prevent negative externalities. The former is ruled out as justification in the context of sophisticated contracting parties.<sup>168</sup> By contrast, externalities could well justify imposing mandatory bankruptcy rules. Waiver contracts may often harm non-consenting parties. For instance, waiving the automatic stay and allowing a creditor to seize debtor assets necessary for running the debtor's business may destroy the going concern value of the business and reduce the amount available for

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<sup>166</sup> Tracht (n 68); E Adams and J Baillie, 'A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay' (1996) 38 Arizona Law Review 1; D Bogart, 'Games Lawyers Play@ waivers of the Automatic Stay in Bankruptcy and the Single Asset Loan Workout (1996) 43 (UCLA Law Review 117; R Efrat, 'The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay (1995) 32 San Diego Law Review 1133; M Baxter, 'Prepetition Waivers of the Automatic Stay: A Secured lender's Guide (1997) 52 Business Lawyer 577; B White, 'The Enforceability of Pre-Petition Waivers of the Automatic Stay (1997) American Bankruptcy Institute Journal 26; F Pearce, 'Bankruptcy-Remote Special Purpose Entities and a Business' Right to Waive its Ability to File for Bankruptcy' (2012) 28 Emory Bankruptcy Developments Journal 507.

<sup>167</sup> Schwarcz (n 68) 516.

<sup>168</sup> *ibid* 535.

distribution.<sup>169</sup> Those contracts that materially reduce the amounts available for distribution to creditors are identified as having ‘a secondary material impact.’ From the point of view of externality analysis, such contracts should be unenforceable; whereas contracts not having a ‘secondary material impact’ should be enforceable.<sup>170</sup> However, in order to realise any potential efficiency gains, parties must be able to rely on a waiver contract’s enforceability *ex ante* even if *ex post* it turns out that the contract has a ‘secondary material impact’. Thus, an *ex ante* standard of assessment is required that can justify the enforceability of a contract despite *ex post* externalities.<sup>171</sup> The tool to measure the quantitative impact of externalities, their materiality, is economic efficiency.<sup>172</sup> For contracts that are *ex ante* unlikely to result in significant negative externalities (‘secondary material impact’), the number of situations where the sum of the gains for debtor and contracting creditor (X+Y) is equal to, or exceed, the aggregate net harm caused to non-consenting creditors (Z) would be expected to be greater than the number of situations where the reverse is true. In aggregate, the sum of all X+Ys would be expected to exceed the sum of all Zs.<sup>173</sup> It follows that waiver contracts that are *ex ante*

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<sup>169</sup> *ibid.*

<sup>170</sup> *ibid* 556.

<sup>171</sup> *ibid* 557.

<sup>172</sup> *ibid* 560. On different concepts of economic efficiency see M Schillig, ‘The Contribution of Law and Economics as a Method of Legal Reasoning in European Private Law’ (2009) 17 *European Review of Private Law* 851, 860-861.

<sup>173</sup> Provided that an event has a greater probability of causing gain than loss, and the magnitude of the gain and loss are equal, a statistically large number of such events would be likely to result in a net gain.



unlikely to result in a secondary material impact would be Kaldor/Hicks efficient and should be enforceable.<sup>174</sup>

However, given the lack of moral justification and legitimacy of decisions based on Kaldor/Hicks vis-à-vis non-consenting parties,<sup>175</sup> Schwarcz relies on the concept of ‘class Pareto efficiency’.<sup>176</sup> ‘A transaction is class Pareto efficient if it is Pareto efficient when each class of persons affected by the class of transactions is viewed as a single collective person. Therefore class Pareto efficiency exists whenever the overall gains to each affected class exceed the losses to such class even if some members of the class lose value.’<sup>177</sup> A decision based on class Pareto efficiency carries greater legitimacy on the basis of freedom of contract: *ex ante* all affected parties would be able to consent to a class Pareto efficient transaction and would want it to be enforceable even if *ex post* some would be harmed.<sup>178</sup> This is in line with the commons/anti-commons analysis. Treating all unsecured creditors as a class alleviates the problem of debt fragmentation and divergent creditor interests. What matters is the class as a whole, thus reducing the risk of holdout and strategic behaviour.

Schwarcz develops a mathematical model on the basis of expected value analysis demonstrating that a reduction in the likelihood of bankruptcy as a consequence of a waiver contract is likely to benefit unsecured creditors as a class in excess of any harm

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<sup>174</sup> Schwarcz (n 68) 561-562.

<sup>175</sup> Schillig (n 172) 861.

<sup>176</sup> Schwarcz (n 68) 563; see also S Schwarcz, ‘The Easy Case for the Priority of Secured Claims in Bankruptcy’ (1997) 47 Duke Law Journal 425, 481.

<sup>177</sup> Schwarcz (1997) (n 176) 481-482.

<sup>178</sup> Schwarcz (n 68) 564.

they may suffer. The model<sup>179</sup> compares the expected value of unsecured claims absent the waiver contract<sup>180</sup> with the expected value of unsecured claims in the presence of the waiver contract<sup>181</sup> on the basis of conservative estimates in accordance with the limited empirical material that is available. The latter expected value is likely to exceed the former where the debtor receives something in return – increased liquidity – that reduces the likelihood of bankruptcy. This would make non-consenting creditors as a class better off and even creditors who are eventually harmed would want these contracts to be enforceable from an *ex ante* point of view.<sup>182</sup> By contrast, the harm arising from externalities would begin to outweigh the benefit from increased liquidity when the likelihood of a secondary material impact exceeds circa 30%. Such contracts are, from an *ex ante* point of view, likely to cause material negative externalities, are therefore not ‘class Pareto efficient’ and should not be enforced. In short, a waiver contract for which

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<sup>179</sup> Based on the assumption that the debtor has one secured creditor who seeks a pre-bankruptcy contract waiving the automatic stay, all other creditors are unsecured, *ibid* 565.

<sup>180</sup> As equal to the ‘likelihood of bankruptcy absent the contract x [nonforeclosure asset value in bankruptcy – amount of the secured claim] + the likelihood of avoiding bankruptcy absent the contract x amount of unsecured claim (assumes payment in full by avoiding bankruptcy)’; *ibid* 569 n 300.

<sup>181</sup> As equal to the ‘likelihood of bankruptcy with the liquidity resulting from the contract x [{chance of an unanticipated secondary material impact occurring x value of the unsecured claims if a secondary material impact occurs} + {chance that an unanticipated secondary impact will not occur x (asset value assuming no secondary material impact – amount of the secured claim)}] + the likelihood of avoiding bankruptcy with liquidity resulting from the contract x amount of unsecured claim (assumes payment in full by avoiding bankruptcy)’; *ibid*.

<sup>182</sup> *ibid* 565-671.

the debtor receives reasonably equivalent value<sup>183</sup> should be enforceable if, viewed *ex ante*, it is unlikely to result in material negative externalities and does not manifestly impair the debtor's ability to rehabilitate.<sup>184</sup> The weakness of this approach is its somewhat simplistic underlying factual assumptions and its dependency on the chosen numbers, although Schwarcz seeks to account for that to some extent.<sup>185</sup> It nevertheless seems to reflect a more general heuristic insight that where a transaction was entered into in good faith and with the best interest of the company in mind subsequent invalidation of the transaction requires some justification, given that both shareholders and creditors invested on the basis of the company's risk profile and, in the absence of fraud or misrepresentation, will have obtained adequate *ex ante* compensation. This does not mean that a common pool problem does no longer exist.<sup>186</sup> Rather, enforceability of the opt-out or partial privatisation is the price the general creditors should be willing and have to pay for a reduction in the probability of insolvency, even if *ex post* insolvency still materialises and actual returns do not meet *ex ante* expectations.

Under English law the general principle that parties cannot contract out of the insolvency legislation embraces two sub-principles: the *pari passu* principle and the anti-deprivation principle.<sup>187</sup> The former concerns the distribution of the debtor's assets in

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<sup>183</sup> In order to ensure that waiver contracts are valued correctly most waiver contracts should be enforceable only if entered into at a time of default, *ibid* 595.

<sup>184</sup> *ibid* 584.

<sup>185</sup> *ibid* 570.

<sup>186</sup> Above text following n 75.

<sup>187</sup> *Belmont* (n 14) [1] – [15] per Lord Collins; Goode (n 2) para 7-01 – 7-03; S Worthington, 'Good Faith, Flawed assets and the Emasculation of the UK Anti-Deprivation Rule' (2012) 75 MLR 112, 112-113.

accordance with the statutory order of priority. It seeks to ensure that all creditors are treated equally on the basis of their pre-insolvency entitlements and that no creditor (or class of creditors) obtains preferential treatment.<sup>188</sup> Contravention of the *pari passu* principle has no impact on the company's balance sheet: assets are exchanged in consideration for the extinction of an existing debt. By contrast, pursuant to the anti-deprivation principle the debtor may not contract at any time, either before or after the commencement of insolvency proceedings, for its property to be removed or disposed of or dealt with otherwise than in accordance with the statute.<sup>189</sup> In principle, the rule seeks to prevent a decrease in the debtor company's net assets available for distribution by removing assets that otherwise would have been available for distribution.<sup>190</sup> Although both principles will overlap where an existing creditor obtains preferential treatment in excess of its pre-insolvency entitlement,<sup>191</sup> conceptually there is a clear distinction

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<sup>188</sup> *British Eagle International Airlines Ltd v Compagnie Air France* [1975] 1 WLR 758, 780G-H, per Lord Cross.

<sup>189</sup> *Ex parte Jay* (1880) LR 14 ChD per James LJ 25: '[A] simple stipulation that upon a man's becoming bankrupt, that which was his property up to the date of bankruptcy should go over to somebody else and be taken away from his creditors, is void as being a violation of the policy of the bankruptcy law.'; *ex parte Mackay* (1873) LR 8 Ch App 643, 647 per James LJ: 'A man is not allowed by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides.'

<sup>190</sup> However, the rule may apply even if assets are not removed and/or if there is no decrease in net assets. Lord Walker pointed out in *Belmont* (n 14) para 149 that there is no conceptual difference between removing specific property from the bankrupt estate for no consideration, increasing the security given to a particular creditor and increasing the bankrupt estate's liability to a particular creditor.

<sup>191</sup> Goode (n 2) para 7-03.

between *pari passu* and anti-deprivation, not always observed by courts in the past.<sup>192</sup> In terms of the commons/anti-commons analysis, *pari passu* concerns the pricing of creditors' property rights in the anti-commons situation through a particular order of priority. Anti-deprivation concerns the conservation of the insolvent estate; by preventing attempts to bypass the collective insolvency regime it seeks to preserve the principle of collectivity itself.<sup>193</sup>

The exact boundaries of the anti-deprivation rule have escaped easy definition. What could be gleaned from the cases was a distinction between interests that were granted as limited so as to come to an end, automatically or by way of termination, when the company goes into winding up; and absolute interests where a party is given the right to recapture the asset upon the debtor's insolvency. Only the latter was considered to offend against the anti-deprivation rule; in the former type of cases the interest never was the outright property of the company.<sup>194</sup> The distinction has often been criticised as being devoid of any clear rationale.<sup>195</sup> In the aftermath of the financial crisis, the scope and ambit of the anti-deprivation principle has come under scrutiny in the context of complex

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<sup>192</sup> Look Chan Ho, 'The principle against divestiture and the *pari passu* fallacy' (2010) 25 *Butterworths Journal of International Banking and Financial Law* 3; but now *Belmont* (n 14) [1] – [15] per Lord Collins; [148] per Lord Mance; *Lomas v Rixson* [2012] EWCA Civ 419 [96] and [97].

<sup>193</sup> Ho (n 192) 4-5.

<sup>194</sup> Goode (n 2) para 7-05; R Calnan, *Proprietary Rights and Insolvency* (Oxford: Oxford University Press, 2010) para 1-20 – 1.21.

<sup>195</sup> Calnan (n 194) para 1-22: 'distinction without a difference'.

financial arrangements.<sup>196</sup> At the heart of the matter is the question to what extent party autonomy can prevail in view of the interests of third party creditors. In *Belmont* the Supreme Court attempted to define the boundaries of the anti-deprivation rule and the role of party autonomy in the context of corporate insolvency.<sup>197</sup>

*Belmont* concerned legal entitlements to priority in security on the collateral provided in a synthetic collateralised debt obligation programme which had been established by Lehman Brothers International (Europe). Special purpose vehicles incorporated in offshore jurisdictions by Lehman Group issued notes to investors using the proceeds to acquire, as collateral, highly rated government bonds and other secure investments. The collateral was vested in a Trustee. Each SPV entered into a credit default swap with a Delaware entity, Lehman Brothers Special Financing Inc (LBSF). Under the swap, LBSF would pay the issuer the amounts due by the issuer to the noteholders in exchange for sums equal to the yield on the collateral. On maturity of the notes (or on early redemption or termination) the amount payable by LBSF to the issuer was the initial principal amount subscribed by the investors less amounts calculated by reference to credit events during a specified period in respect of one or more reference entities. The SPV's exposure to LBSF under the credit default swap and to the noteholders was secured on the collateral. The terms of the arrangement provided that the

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<sup>196</sup> In addition to *Belmont* (n 14) see also *Lomas* (n 192); *Folgate London Market Ltd (formerly Towergate Stafford Knight Co Ltd) v Chaucer Insurance Plc* [2011] EWCA Civ 328; *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718 (Ch).

<sup>197</sup> *Belmont* (n 14); see also *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch); *Butters and others v BBC Worldwide Ltd and others* [2009] EWHC 1954 (Ch.); *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160.

charge over the collateral would become enforceable if any amount due in respect of the notes was not paid or delivered when due. Any money the trustee obtained in realisation of the collateral had to be applied first with ‘swap counterparty priority’ in favour of LBSF unless an event of default had occurred under the swap agreement and the swap counter party was the defaulting party, in which case the noteholders would have priority.<sup>198</sup> LBSF filed for Chapter 11 on 3 October 2008 following its parent company which had filed two weeks earlier on 15 September 2008.<sup>199</sup> Both filings constituted an event of default, triggering the priority flip from swap counter party priority to noteholder priority. LBSF argued that the effect was to deprive its estate of property in the event of a bankruptcy filing which would otherwise have been available for distribution among the creditors.<sup>200</sup>

Both High Court and Court of Appeal held that the ‘priority flip’ did not offend the anti-deprivation rule. This was confirmed by the Supreme Court. Lord Collins,

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<sup>198</sup> *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160 para. 5 per Lord Neuberger MR.

<sup>199</sup> On the private international law implications of the anti-deprivation principle see T Cleary, ‘Lehman Brothers and the anti-deprivation principle: current uncertainties and proposals for reform’ (2011) 6 Capital Markets Law Journal 411, 417-426. It seems that the anti-deprivation principle can be invoked in the English courts if the transaction is governed by English law (as the applicable law of the underlying contract) and the insolvency proceedings, if not under the Insolvency Act 1986, are similar to liquidation or administration. However, Briggs J. said *obiter* that he had ‘grave difficulty’ with this conclusion: *In the matter of Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) para 59-62.

<sup>200</sup> *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch) para. 3-6.

delivering the majority opinion of the Court,<sup>201</sup> tried to establish workable principles for the demarcation of the anti-deprivation rule. It was desirable for courts to give, as far as possible, effect to contractual terms which the parties have agreed, in particular in the context of complex financial instruments. The modern tendency has been to uphold commercially justifiable contractual provisions. The policy behind the anti-deprivation rule was to prevent parties from depriving the debtor of property which would otherwise be available for creditors. The anti-deprivation principle was essentially directed at intentional or inevitable evasion of the principle that the debtor's property is part of the insolvent estate. It must be applied in a commercially sensitive manner, upholding proper commercial bargains.<sup>202</sup> What was decisive in the case at issue was 'the fact that this was a complex commercial transaction entered into in good faith.'<sup>203</sup> The provisions were not intended to evade insolvency law as was obvious from the wide range of non-insolvency circumstances capable of constituting an Event of Default triggering the priority switch.

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<sup>201</sup> Lord Mance adopted a different approach that led him to the same result. This approach is objective and based on the familiar 'limited (flawed) asset/absolute interest' dichotomy. His line of argument is twofold: prior to the occurrence of an event determining whether counterparty priority or noteholder priority applies, LBSF did not enjoy a property right that it could be deprived off [168]; even if it was assumed that LBSF was deprived of a property right, this would be a legitimate deprivation. Following the reasoning of Briggs J at first instance in *Lomas*, '[w]here a contract provides for the performance in the future of reciprocal obligations, the performance of each of which is the *quid pro quo* of the other' there is nothing objectionable about a provision entitling one party to terminate his obligation and interests in collateral provided for it if the other becomes bankrupt [179]. For a critique of this approach Worthington (n 189) 118-120.

<sup>202</sup> *Belmont* (n 14) [102]-[106] *per* Lord Collins.

<sup>203</sup> *ibid* [108].



Moreover, ‘the substance of the matter [was] that the security was provided by the Noteholders and subject to a potential change in priorities.’<sup>204</sup> The noteholder priority was intended to deal with the risk that LBSF was not in a position to provide sufficient funds to the Issuers for them to pay the noteholders. As such, it seems to have been a material factor in obtaining Triple A credit ratings which enabled Lehman to market the notes.<sup>205</sup> According to the Court of Appeal in *Lomas*, this test must now be accepted as an authoritative statement of the anti-deprivation principle. Consequently, in rejection of the flawed asset theory, each transaction has to be assessed on its own merits in order to distinguish between a commercial re-arrangement of rights to reflect the economic consequences of insolvency and an attempt to pre-empt the distribution of assets in a bankrupt estate.<sup>206</sup>

In addition to doctrinal arguments,<sup>207</sup> the Supreme Court’s approach has been criticised for its inherent uncertainty. It will often be difficult to determine whether a

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<sup>204</sup> *ibid.*

<sup>205</sup> *ibid* [112]-[113]. In addition, Lord Walker saw a valuable contribution to the search for principle in this area in Briggs J.’s observation at first instance in *Lomas* concerning situations where the insolvent company’s asset is a chose in action ([131]). Where the right in question was *quid pro quo* for services yet to be rendered or something still to be supplied by the insolvent party in an ongoing contract, the court would readily permit the coming to an end of such interest. There was nothing contrary to insolvency law in permitting a party either to terminate or adjust what would otherwise be an ongoing relationship with the insolvent company when it enters the insolvency process; *Lomas v JFB Firth Rixson Inc (International Swaps and Derivatives Association Inc Intervening)* [2010] EWHC 3372 (Ch) [108]-[110].

<sup>206</sup> *Lomas* (n 192) [86], [91].

<sup>207</sup> On the basis that the authorities do not carry a subjective approach based on intention/good faith; *Worthington* (n 187) 116.

certain deprivation provision was entered into in good faith or whether there was an intention to bypass the collective insolvency procedure. When a company enters into a transaction it will more often than not do so on the assumption that it will not become insolvent and agree to a deprivation provision in return for some commercial advantage,<sup>208</sup> possibly in form of a reduction of its costs of credit. In that scenario the transaction may well be a ‘proper commercial bargain’. On the other hand, an intention may be inferred from the mere presence of a deprivation clause. However, ‘in borderline cases a commercially sensible transaction entered into in good faith’ should not be invalidated under the anti-deprivation principle.<sup>209</sup> It is not clear what would make a case ‘borderline’. The fact that not all, but only some, deprivation clauses seem to justify an inference of intention would suggest that what is really at issue is not intention or good faith as such but whether and to what extent there is actually deprivation.<sup>210</sup> According to Worthington, the reliance on good faith glosses over this essential question. Moreover, if the purpose of the anti-deprivation principle is to preserve the estate for the creditors collectively it is difficult to see why a transaction that results in a depletion of the company’s assets should be upheld simply because this depletion was unintentional.<sup>211</sup> The anti-deprivation rationale does not seem to leave room for good faith or intention. This is confirmed by the fact that for an infringement of the *pari passu* principle the

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<sup>208</sup> Cleary (n 199) 416.

<sup>209</sup> *Belmont* (n 14) [79] *per* Lord Collins

<sup>210</sup> Worthington (n 187) 117.

<sup>211</sup> *ibid* 117; Cleary (n 199) 416.

intention of the parties and good faith is immaterial; all that matters is the effect of an agreement.<sup>212</sup>

It seems possibly to counter these objections on the basis of the ‘waiver contract approach.’ The Supreme Court’s reasoning seems to be in accordance with the concept of ‘class Pareto efficiency’. Whilst keen to give effect to contractual terms so far as possible, the Court is mindful of party autonomy being limited by the adverse effect contractual arrangements may have on the rights of third parties,<sup>213</sup> in other words negative externalities or a ‘secondary material impact’. Under the waiver contract approach, contracts that *ex ante* are unlikely to result in significant negative externalities should be enforceable. This finds its expression in Lord Collins’ analysis, that the anti-deprivation rule should not be applied to bona fide commercial transactions which do not have as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties.<sup>214</sup> If a transaction has a proper business purpose it is more likely than not that the debtor company receives some benefit in return otherwise it would not have contracted. Deprivation not being a predominant purpose makes it less likely that a ‘secondary material impact’ will in fact occur. As we have seen, in order to meet the ‘class Pareto requirement’, under the bankruptcy contract the debtor must receive something in return – reasonably equivalent value – that reduces the likelihood of bankruptcy. This requirement is reflected in the notion that the source of the collateral may matter. In Lord Walker’s words, ‘the noteholders were, as a matter of substance, the

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<sup>212</sup> Worthington (n 187) 117.

<sup>213</sup> *Belmont* (n 14) [103] *per* Lord Collins.

<sup>214</sup> *ibid* [104].

only party who contributed real assets’.<sup>215</sup> This and the priority flip seem to have been necessary to obtain a high credit rating that was essential for marketing the notes. Thus, LBSF and its creditors were able to benefit from the priority flip provision *ex ante*. Sophisticated investors (in LBSF) would have been aware of the widespread use of these and similar clauses and would be able to price their investments accordingly so as to obtain appropriate *ex ante* compensation. Consequently, the clause would meet the ‘class Pareto efficiency’ test.

The reliance on good faith and the parties’ intentions is essential in order to allow the *ex ante* assessment of the enforceability of a contract. The subjectivity of the test may result in uncertainty in individual cases. However, a ‘bright line approach’ would itself be costly. One extreme would be to give parties (almost) free reign.<sup>216</sup> This would largely bypass the law on secured credit. The extensive use of ‘invisible’ quasi security would be likely to significantly decrease any chance of preserving a possible going concern value and would render a moratorium futile.<sup>217</sup> The other extreme would be a rule similar to the US prohibition of *ipso facto* provisions, as advocated by Professor Sir Roy Goode.<sup>218</sup> In parallel proceedings in the US, involving different noteholders but not *Belmont*, Judge Peck held that the ‘priority flips’ constituted unenforceable *ipso facto* clauses violating 11

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<sup>215</sup> *ibid* [132] *per* Lord Walker.

<sup>216</sup> Calnan (n 194) para 1-39; Ho (n 194) 7-8.

<sup>217</sup> German insolvency law prior to the Insolvency Act of 1999 provides an example. Due to the proliferation of ‘invisible’ quasi security interests many estates were so short of assets that they did not even cover the costs of the insolvency proceedings (‘the bankruptcy of bankruptcy law’), S Smid, *Praxishandbuch Insolvenzrecht* (Berlin: de Gruyter, 5<sup>th</sup> edn 2007) 11-12.

<sup>218</sup> Goode (n 2) para 7-05.

USC §§ 365(e)(1) and 541(c)(1)(B) and that any action to enforce such provisions as a result of LBSF's bankruptcy filing would violate the automatic stay under 11 USC § 362(a).<sup>219</sup> Such general unenforceability would prevent any legitimate contracting,<sup>220</sup> subject only to certain safe harbour exceptions.<sup>221</sup> On the basis of our analysis above, it may result in the actual destruction of going concern surplus. Moreover, a clear objective test of what transactions offend the anti-deprivation principle has eluded courts and commentators for 200 years. Besides, courts are used to making subjective good faith assessments all the time, be it in the context of undervalue transactions, preferences, transactions defrauding creditors or wrongful trading.<sup>222</sup> There is little reason to assume that they would not be capable of fleshing out the anti-deprivation principle on the basis of the Supreme Court's test, in particular when enriched with the considerations of the waiver contract approach.

## F. CONCLUSION

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<sup>219</sup> *Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Ltd*, 422 BR 407 (US Bankruptcy Court, SDNY, 2010).

<sup>220</sup> Cleary (n 199) 431. Cleary's own test occupies a compromise position between these two extremes, but is in substance very similar to the Supreme Court's, albeit much more complex.

<sup>221</sup> 11 USC §§559 – 561 protecting liquidation, termination, acceleration and close-out netting clauses in repo and derivative contracts. These are themselves subject to critique, S Lubben, 'Derivatives and Bankruptcy: The Flawed Case for Special Treatment' (2009) 12 University of Pennsylvania Journal of Business Law 61.

<sup>222</sup> Cleary (n 199) 440.

The commons/anti-commons analysis explains much of what is going on in corporate insolvency law.<sup>223</sup> It justifies the existence of mandatory provisions such as a comprehensive automatic stay/moratorium, information rights, majority voting and cram down. At the same time it provides the basis for enhanced party autonomy. Financial innovation resulting in the fragmentation of debt, ever increasing complexity of proprietary rights and distorted incentives of rights holders may render traditional mechanisms ineffective. In this respect, commons/anti-commons analysis can be combined with ‘contractualisation of bankruptcy’ models in order to redefine the boundaries of mandatory law and contract.

The ‘menu approach’ addresses the anti-commons problem through the *ex ante* and *ex post* re-pricing of the property rights of those who are locked in a collective procedure in order to make cooperation more likely. It finds an expression in the concept of the COMI pursuant to Arts 3 and 4 EUIR. COMI should be reformed by adopting a pure incorporation/registered office test. Moreover, the issues ensuing from a transfer of COMI should be addressed in a future instrument on the transfer of a company’s registered office. The ‘bankruptcy contract approach’ offers an analytical tool for allowing parties to change from ‘collectivisation’ to ‘privatisation’ and *vice versa*. The former is reflected in the current practice of pre-packaged administrations. Empirical evidence suggests that pre-packs are beneficial to all parties concerned, providing a strong argument in favour of not restricting party autonomy in this respect. A move from ‘privatisation’ to ‘collectivisation’ may become possible under the proposed restructuring moratorium. The ‘waiver contract approach’ provides a standard for assessing which

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<sup>223</sup> See de Weijts (n 9).

contractual arrangements overriding insolvency law provisions should be enforceable from an *ex ante* perspective. This approach justifies the Supreme Court's test for identifying transactions that offend the anti-deprivation principle, based on a desire to uphold *bona fide* commercial transactions, whilst at the same time addressing the externalities problem.

In these instances, we can observe a market-driven re-alignment of the boundaries between mandatory corporate insolvency law and private ordering. The analytical framework developed here, suggests that mandatory corporate insolvency law should not be an end in itself. Rather, it is a means for addressing certain market failures in form of common pool and anti-commons problems. Where mandatory law fails to achieve its objectives and becomes counter-productive, it should make room for market-based solutions and should retreat to providing the structural rules necessary to facilitate private ordering. This is the underlying theme that connects and justifies the developments discussed in this article.